TEXAS GULF SULPHUR; REFORM IN THE SECURITIES MARKETPLACE

GILBERT SANDLER* AND ALLAN F. CONWILL†

On August 13, 1968, the United States Court of Appeals for the Second Circuit handed down, after some seventeen months of deliberation involving all nine members of one of the most sophisticated corporate law tribunals in the country, a decision destined from its very inception to become the landmark case in the regulation of securities transactions and corporate disclosure. The result in *SEC v. Texas Gulf Sulphur Co.*[1] surprised few informed members of the securities industry or their counsel, but the vast implications of the opinion stunned the professional investment community by rudely reawakening them to the impropriety of the long-established practice of profiting, and enabling others to profit, from advance knowledge of material information affecting the market price of securities. The purpose of this article is to review the express and implied teachings of the decision, its apparently intended and actual effect on the investment community, and its proper application to factual situations not presented in *Texas Gulf.*

I. THE DECISION

A. *The Factual Setting*

The background of the case has been succinctly developed in the opinions of both the Second Circuit[2] and of the District Court[3] as well as in more narrative contexts.[4] For present purposes, it will suffice to summarize some of the pertinent events and to make more specific references in the course of subsequent discussion.

In November 1963, Texas Gulf Sulphur (hereinafter referred to as TGS) commenced exploratory drilling on the "Kidd" segment of an undeveloped parcel of land near Timmins, Ontario, in which,

* Member of the New York Bar; A.B. Rutgers University, 1963; LL.B. Columbia Law School 1966.

† Member of the New York Bar; B.S. Northwestern University, 1943; J.D. Northwestern Law School 1949; Lecturer at Law, Columbia Law School.

1 401 F.2d 833 (2d Cir. 1968), *cert. denied sub. nom.* Coates v. SEC, 37 U.S.L.W. 3395 (U.S. Apr. 22, 1969); Kline v. SEC, 37 U.S.L.W. 3395 (U.S. Apr. 22, 1969), as to these petitioners.

2 *Id.*

3 258 F. Supp. 262, 267-75, 281-96 (S.D.N.Y. 1966).

4 *See, e.g.,* Brooks, *Annals of Finance: A Reasonable Amount of Time,* THE NEW YORKER, Nov. 8, 1968, at 160-88, for a particularly entertaining description of the events in question.

according to previous geological examination, there were large and contiguous "anomalies" or areas of potential mineralization. A first drill core was extracted and was visually evaluated as remarkably rich in copper, zinc and silver. Immediately thereafter, this drill core was sent to the United States for a more accurate chemical assay, tight security measures were imposed on the drill site, and negotiations were begun for the acquisition by TGS of other portions of the Kidd property not yet owned by it. Simultaneously with these preparations, several TGS officers or employees who knew about this first drill core began purchasing TGS stock at prices ranging from 17⅝ to 18⅛. Early in December, the chemical assay confirmed TGS's most optimistic expectations concerning the initial core and these same and other informed TGS personnel (and certain of their relatives and associates) purchased large quantities of TGS stock and short-term calls thereon at slightly higher prices. These purchases continued through the acquisition of the Kidd parcel on March 27, 1964, and the resumption of drilling on the site on March 31 until April 8, 1964.

By that date, three drill holes had established substantial mineralization of virtually the same quality as the first hole on the eastern perimeter of the large Kidd anomaly and additional drilling rigs were introduced to commence drilling at westerly angles to the east and north of the first hole. By Friday, April 10, these two holes had encountered mineralization and rumors of a major strike were rife in Canadian mining circles. The next morning brought many of these rumors into American homes with the appearance of reports of TGS's exploratory activities in major New York newspapers. TGS officials hastily conferred and prepared a press release over the weekend. This release, issued April 12 for dissemination on Monday, April 13, generally denied the circulating rumors and disclosed nothing concerning developments at Timmins, except that preliminary indications were favorable and warranted further exploration.

On the basis of the drilling results known to the TGS officials who prepared the release, Securities and Exchange Commission experts later estimated an indicated TGS discovery of approximately six to eight million tons of "proven" ore[5] having gross assay values of nearly 30 dollars per ton. Continued drilling over the weekend produced a sixth hole encountering mineralization. On the basis of the available information, which had not, but conceivably could have been obtained by the draftsmen of the TGS press release by

5 This estimate discounted, of course, the possibility, however unlikely, of a discontinuity in mineralization between the 5 holes already drilled.

the time of its issuance, the *Northern Miner*, an influential Canadian mining journal, announced the confirmation of a ten million ton strike. Having found some small mineralization in two additional holes, TGS released on April 15 to the Ontario Minister of Mines a statement reporting a twenty-five ton million strike.

Meanwhile, the April 12 release had taken its intended effect and the market price of TGS stock declined from a high of 32, prior to digestion of the release, to a low of 28⅞ on April 15. TGS now determined to issue a complete report of its major discovery after its scheduled board of directors meeting on April 16. Certain officials who knew of the impending announcement ordered additional purchases of TGS stock prior to its release. Another ordered stock for his trust accounts immeditely after the announcement but before its appearance on the Dow Jones "broad tape," and yet another relayed the general good tidings to a broker relative before such appearance on the tape and purchased stock for his own account a few hours later.

The Commission alleged in its complaint that the various TGS personnel who had purchased TGS stock and calls prior to effective dissemination of the ore strike had exploited material inside information in violation of section 10(b) of the Securities Exchange Act of 1934[6] and Rule 10b-5[7] promulgated by the Commission there-

---

6 15 U.S.C. § 78 j. This provision reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

7 17 C.F.R. § 240.10b-5 provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

under. It was also claimed that the April 12 press release of TGS denying the rumors of a strike was materially misleading in violation of the Rule. Furthermore, the Commission alleged that the TGS geologist working on the drill site had improperly "tipped" several friends, resulting in their purchases of stock and calls, and that Rule 10b-5 had also been breached by the acceptance, in February of 1964, of stock options by certain TGS officials aware of the first remarkable Kidd drill core. An injunction restraining future similar misconduct and compelling disgorgement of insiders' profits was sought, the availability and assessment of damages to numerous private plaintiffs being deferred for future resolution after violations had been determined.

B. *The District Court Decision*

Judge Bonsal, sitting in the District Court, heard testimony from the alleged insiders, TGS officials and experts, SEC experts and various mining security specialists; the depositions of the absent TGS geologist claimed to have "tipped" and his alleged "tippees" were received in their absence from the trial. Relying on the supposition that the test of whether the information concerning the first drill core was "material" must necessarily be a conservative one[8] and on the TGS experts' insistence that one or even two intersecting drill cores did not a mine (nor earnings) make,[9] Judge Bonsal held that the insider purchases prior to the drilling of the third hole on April 9[10] were not based on their use or possession of information, but rather on their "educated" guesses[11] and hopes, albeit "perhaps with some reason."[12] Thus, insiders who had no detailed knowledge of the drilling results[13] and those who had traded only prior to April 9 were exculpated. And the court was able to avoid passing upon

8 258 F. Supp. at 280: "Material information . . . is information which, if known, would *clearly* affect 'investment judgment' . . . or which *directly* bears on the intrinsic value of a company's stock . . . But the test of materiality must necessarily be a *conservative* one . . ." (Emphasis supplied; citations omitted.)

9 258 F. Supp. at 282-84.

10 *Id.* at 282. This hole established that the vertical plane of mineralization revealed by the first two holes extended southward 200 feet.

11 258 F. Supp. at 284.

12 *Id.* at 283.

13 Huntington, a TGS attorney who knew only that TGS was quite anxious to acquire the Kidd property was held not to have material information when he bought TGS stock; Murray knew nothing at all of the drilling and was likewise exculpated. 258 F. Supp. at 281. Kline, who had accepted stock options with knowledge that the first drill core was favorable, was also exonerated. *Id.* at 291.

whether Darke, the geologist, had violated Rule 10b-5 by tipping and whether various insiders had violated the Rule by accepting stock options at a price which might not have reflected their then fair market value.

Clayton and Crawford, who had purchased or ordered TGS stock the day before the April 16 release, were held, however, then to have been in possession of material inside information, for after April 9, "there was real evidence that a body of commercially mineable ore might exist."[14] The charges against Coates and Lamont, who had traded and passed information after the issuance of the release but before its appearance on the broad tape and perhaps before its digestion by the investment community, were dismissed by reason of the court's view that insiders could act immediately upon release of material information and without the "reasonable waiting period" sought by the SEC.[15]

TGS itself was exonerated for having issued the April 12 release denying rumors of a strike near Timmins for several reasons. First, Judge Bonsal held that since neither TGS nor any of the draftsmen had traded as a result of, or with the assistance of, the release, it had not been issued "in connection with the purchase or sale of a security" as required by the language of Rule 10b-5.[16] In addition, he found that the release was not materially misleading "on the basis of the facts then known" to TGS draftsmen and that their exercise of "reasonable business judgment" in the exigencies of the situation was sufficient to exculpate them.[17]

Needless to say, the Commission appealed from the decision of Judge Bonsal, as did the insiders who had been held to have violated Rule 10b-5.[18]

C. *The Second Circuit Decision*

The cross-appeals of the Commission and the various defendants were originally argued in March 1967, before a panel consist-

---

14 258 F. Supp. at 282.

15 *Id.* at 288-90.

16 *Id.* at 294.

17 *Id.* at 294-96.

18 The SEC did not appeal from Judge Bonsal's exoneration of Murray as having no knowledge of the drilling developments or from his holding that Holyk and Mollison could accept the stock options granted them since they were not members of top management and could expect others to disclose, though the court apparently considered the status of these defendants. *See* 401 F.2d at 842. In addition, the death of Lamont while the appeal was *sub judice* resulted in an order dismissing the complaint as to him. *See id*, at 842 n.6.

ing of Judges Waterman, Moore and Hays. After nearly a year of deliberation, the case was submitted without additional argument to the entire court *en banc*, which resulted on August 13, 1968, in a reversal of the significant portion of the District Court's opinion, and included (1) a majority opinion[19] written by Judge Waterman, adopted by Judges Smith and Feinberg, wholly concurred in by Judges Kaufman and Anderson, and partially concurred in by Judges Friendly and Hays; (2) a concurring opinion by Judge Friendly, adopted in part by Judges Kaufman and Anderson; (3) a concurring and dissenting opinion by Judge Hays, and (4) a dissenting opinion by Judge Moore, adopted by Chief Judge Lumbard.

1. Insiders

The court first expanded the District Court's definition of the class of insiders subject to Rule 10b-5. While Judge Bonsal had observed that ". . . insiders . . . may include employees as well as officers, directors and controlling stockholders who are in possession of material undisclosed information, . . . "[20] Judge Waterman included "anyone who . . . has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' . . ." and ". . . anyone in possession of material inside information. . . ."[21] No express consideration was given to the potential overlap of coverage by both section 16(b) and Rule 10b-5, though the court unequivocally rejected the contention made by defendants below that Rule 10b-5 should be applied only to officers, directors and shareholders subject to section 16.

2. Materiality

Next, the court, though agreeing with much of Judge Bonsal's language and citation of authority with respect to "materiality," undertook a major revision of his definition in its application to the facts presented. In definitively rejecting Judge Bonsal's statement that "the test of materiality must necessarily be a conservative one" as applied to deny speculative investors Rule 10b-5 protection as to facts of interest to them, Judge Waterman merely expanded

19 Unless otherwise indicated, the opinion of the court hereinafter referred to will be the majority opinion of Judge Waterman.

20 258 F. Supp. at 279.

21 401 F.2d at 848.

the class of "reasonable" investors[22] by whom "materiality" is determined under the rule of *List v. Fashion Park, Inc.*[23]

> Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell or hold the company's securities.[24]

The court did not, however, go so far as to deem material information as to the mere possibility of corporate development which, if consummated, would be important to the hypothetical reasonable investor. In such a case, materiality

> . . . will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.[25]

This balancing standard was apparently suggested as an approximation of the effect of knowledge of a particular event upon the reasonable investor, in conjunction with Judge Waterman's prior statement that material events

> . . . are essentially extraordinary in nature and . . . are reasonably certain to have a substantial effect on the market price of the security if . . . disclosed.[26]

Applying the foregoing principles, the court held that knowledge of the results of the *first* drill core was material because as evidenced by the testimony of mining stock specialists and, particularly, by the unusual and excessive trading by insiders, even the mere *possibility* of an ore strike as remarkably rich as was indicated by the visual assay within a vast area of mineralization would have influenced ". . . a reasonable, if speculative, investor. . . ."[27] Thus, the insider trading from November 12, 1963, the date of extraction of K55-1, the first drill core, until prior to effective public disclosure by those who had express or implied[28] knowledge of the extremely

22 *Id.* at 849.

23 340 F.2d 457, 462 (2d Cir. 1964); *cert. denied sub nom,* List v. Lerner, 382 U.S. 811 (1965).

24 401 F.2d at 849.

25 *Id.*

26 *Id.* at 848.

27 *Id.* at 850.

28 The court held Huntington had violated Rule 10b-5 though he had no detailed knowledge of the drilling results because he had participated in the land acquisition

favorable nature of the drilling results was found to violate Rule 10b-5. In response to the argument that legitimate corporate objectives precluded early disclosure of preliminary drilling results, the court invoked the correlative duty, announced by the SEC in *In re Cady, Roberts & Co.*,[29] of abstention from trading.[30]

3. Tipping

Having determined that Darke, the TGS geologist, did indeed possess material information when he told personal friends that TGS stock "was a good buy" and that an insider's duty of abstention extends to "recommending"[31] as well as trading for one's own account,[32] the court was confronted with an incomplete record as to what information had been passed by Darke to his alleged "tippees." The majority[33] of the nine members of the *en banc* court relied on Judge Bonsal's findings that Darke had said that TGS stock "was a good buy" and, particularly, upon the findings below that the synchronization of tippee transactions to drilling developments constituted "strong circumstantial evidence that Darke must have passed the word to one or more of his 'tippees' that drilling . . . was about to be resumed,"[34] which, in turn, justified the inference of prior tipping; accordingly, they held Darke had violated Rule 10b-5 by tipping. Without considering the liability of Darke's tippees or tippees generally, the court clearly laid the groundwork for future tippee liability by rather bluntly stating that ". . . if they acted with actual or constructive knowledge that the material information was undisclosed . . ." tippees might violate Rule 10b-5, as they were "equally reprehensible" as their tipping source.[35]

---

program and, as evidenced by his purchase of TGS stock and, for the first time, short-term calls, he had a "readily inferable and probably reliable understanding of the highly favorable nature of preliminary operations." 401 F.2d at 853.

29 40 S.E.C. 907 (1961).

30 401 F.2d at 848, 850 n.12.

31 *Id.* at 848.

32 The court indicated that transactions by wives and sons-in-law of insiders were to be treated as insider trading, rather than the results of "tips" to members of the general public. 401 F.2d at 841 n.4, 856 n.23. Although this distinction appears insignificant in *Texas Gulf* because the only defendants were insiders, it can become meaningful if, "tippees" are ultimately held liable under Rule 10b-5, perhaps under different standards than insiders.

33 Judges Waterman and Anderson preferred to remand for a determination as to ". . . whether Darke, expressly or by implication, transmitted to these outsiders any indication of the extremely favorable results of the drilling operations. . . ." 401 F.2d at 852-53 n.16.

34 401 F.2d at 852.

35 *Id.* at 852-53.

4. Stock Options

Although the Second Circuit affirmed Judge Bonsal's exculpation of insider optionees who were not members of "top management," in view of its expansion of the lower court's materiality concept, it became necessary to reverse the exoneration of "top management" optionees[36] and hold that they violated Rule 10b-5 by accepting options to purchase TGS stock at a time when the market price (to which the option price was geared) did not fully reflect the value of TGS stock, without having disclosed to the option committee their material information[37] concerning the drilling operation.[38] It was noted in passing that if the need for corporate security should preclude disclosure to an issuer's option committee, one possible alternative might be to permit the acceptance of options so long as they were not exercised until after full disclosure and a subsequent ratification.[39] However, absent a sound showing that corporate secrecy prevented advising the committee to postpone issuing the options, the court refused to apply this alternative to exculpate Kline, an officer whose options had been ratified after disclosure. Judge Friendly suggested that TGS top management, without breaching the required secrecy, could readily have advised their directors comprising the option committee that it was then untimely to grant options. He further noted that the issuer of undervalued options in such a case might have a claim against silent members of top management.[40]

5. Effective Public Disclosure

The court affirmed Judge Bonsal's holding that Coates had violated Rule 10b-5 by *ordering* the purchase of TGS stock before the April 16, 1964, formal press release had been issued despite his argument that such orders were not *executed* until the next day, and that, in any event, the news of the strike was sufficiently public because of the widespread circulation of rumors, the appearance of a *Northern Miner* article early on April 16 reporting the strike, and the announcement at 9:40 A.M. on the 16th by the Canadian Min-

36 The court disagreed with Judge Bonsal's finding that Kline, a TGS vice-president and its secretary, its general counsel at the time the options were granted, was not a member of "top management." *Id.* at 857.

37 As in the case of Huntington (*see* note 28, *supra*), Kline was held despite his ignorance of the details of the drilling because he knew generally of the favorable developments on the Kidd property. *Id.* at 857 n.24.

38 *Id.* at 856-57.

39 *Id.* at 857 n.24.

40 *Id.* at 865. (Friendly concurring).

ister of Mines. Judge Waterman reasoned, first, that disclosure must be effective at the time of the placing of an order, rather than at the time of its execution, in order to prevent insiders from gaining an advantage in terms of additional time to evaluate information and communicate investment decisions.[41] Next, the rumors and Canadian disclosures were deemed grossly inadequate substitutes for the full formal disclosure required of an issuer with many American shareholders, particularly since TGS had promised in its April 12 release to further advise American investors.[42]

With respect to Coates, who had acted immediately after the April 16 release had been read to the press and before its anticipated or actual appearance over the Dow Jones broad tape, the court reversed Judge Bonsal.[43] It held that, even assuming the news of the TGS strike could be instantly evaluated, insiders were required to wait at least until such information became available to investors generally through the financial media of widest circulation, the broad tape.[44] Significantly, Judge Waterman noted that

> . . . where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination.[45]

6. Insiders' Defenses

Coates, Crawford and Clayton argued on appeal that Rule 10b-5 could not be applied to their purchase orders placed before disclosure became effective because they honestly believed such disclosure had already been made. In rejecting these claims, the court approved the decision of Judge Bonsal[46] and other courts and commentators.[47] Although the court held only that the insiders' unreasonable belief that effective disclosure had been made amounted to negligence which violated the proper standard of the Rule in an enforcement proceeding for equitable or prophylactic relief,[48] Judge Waterman's

---

41 *Id.* at 853 n.17.

42 *Id.* at 853-54.

43 Judge Bonsal had held that ". . . the making of the announcement . . . controls." 258 F. Supp. at 288.

44 401 F.2d at 854.

45 *Id.* at 854 n.18.

46 258 F. Supp. at 277, 286.

47 401 F.2d a 854-55.

48 *See* authorities cited, *id.* at 855.

opinion clearly implied that a negligence standard would also be employed in private actions against insiders.[49]

7. The Press Release

Judge Bonsal had held that the issuance by TGS of its April 12, 1964, release, categorically denying the rumors of a strike without disclosing the underlying facts existing as of the time of issuance, could not violate Rule 10b-5 absent proof of a wrongful purpose in its issuance, *i.e.*, transactions by TGS or insiders, since it could not, in his view, have been issued "in connection with the purchase or sale of any security."[50] The Second Circuit, however, adopted a broader construction of that phrase more consonant, in its view, with the congressional design of protecting "the interest of the invester"[51] by requiring "honest publicity"[52] and "true and accurate corporate reporting."[53] Since the "in connection with" language selected by Congress meant only that the vehicle used ". . . be of a sort which would cause reasonable investors to rely thereon . . . [and] cause them to purchase or sell . . ."[54] a security, the court held that corporate publicity is subject to the accuracy strictures of the Rule whenever disseminated ". . . in a manner reasonably calculated to influence the investing public, *e.g.*, by means of the financial media, . . ."[55]

Next, the court took issue with Judge Bonsal's view that the conduct of the TGS draftsmen was to be determined "on the basis of the facts then known" to them.[56] Rather, the appropriate standard, for the application of which a remand was deemed necessary, was whether the release would have misled or deceived "the reasonable investor, in the exercise of due care,"[57] into believing the situ-

---

49 *Id.* at 855:

A similar [negligence] standard has been adopted in private actions . . . [omitting citations], for policy reasons which seem perfectly consistent with the broad congressional design "* * * to insure the maintenance of fair and honest markets in * * * [securities] transactions."

50 258 F. Supp. at 294.

51 S. Rep. 792, 73d Cong., 2d Sess. 18 (1934).

52 H. R. Rep. 1383, 73d Cong., 2d Sess. 11 (1934).

53 *Id.*

54 401 F.2d at 860.

55 *Id.* at 862.

56 258 F. Supp. at 295.

57 401 F.2d at 863. For itself, the court seemed quite convinced that the release was misleading. *See also id.* at 862 n.28, 862-63 (Friendly J., concurring) and 869-70 (Hays J., concurring and dissenting).

ation was materially different than it actually was at the time of its dissemination or as of the stated time of preparation.[58] If, as urged by TGS, no definitive conclusions or reliable projections were then possible and some statement was necessary to clarify the rumors, it should have, according to the court, specifically described the known drilling progress as of the most current available report by divulging the basic facts and indicating that the situation was rapidly changing, whether or not such disclosure would have encouraged the "rumor mill."[59]

Finally, the court rejected Judge Bonsal's insulation of TGS by virtue of its officers' exercise of "reasonable business judgment" under the circumstances.[60] Having found that the trial judge had applied an incorrect legal standard by which to assess TGS's conduct in issuing the release, the court remanded for a determination as to whether, if the release was found to be misleading to the reasonable investor, its issuance in such form resulted from a lack of due diligence on the part of its draftsmen. In thus applying a negligence standard of conduct to the corporation under clause (2) of Rule 10b-5 the court acted consistently with its approach to insiders' liability under clause (3) of the Rule. Notably, however, this holding was limited, for the moment at least, to actions for injunctive relief,[61] and Judge Friendly's concurrence, with which Judges Kaufman and Anderson agreed (as would the two dissenting judges) on this point, clearly disapproved of the application of a negligence standard in private actions for damages against the issuer of a misleading release.[62]

D. *The Dissent*

Judge Moore was joined by Chief Judge Lumbard in a vehement dissent from the majority's investor-oriented construction of Rule 10b-5. First, the dissenters urged that the TGS insiders' knowledge of the drilling progress prior to April 9 (when Judge Bonsal first deemed the drilling to be material) should not be held material because disclosure of such progress would have been premature and subject to the Commission's censure.[63] They claimed that disclosure of the basic facts regarding K55-1 without conclusory assertions as

58 *Id.* at 864 (Friendly J., concurring).
59 *Id.* at 863-64 (Friendly J., concurring).
60 258 F. Supp. at 296.
61 401 F.2d 833, at 863.
62 *Id.* at 866-68 (Friendly J., concurring).
63 *Id.* at 873 (Moore J., dissenting).

suggested by the majority would have been of no interest to anyone except "possibly a few graduates of Institutes of Technology."[64] The majority was further criticized for having placed any reliance in determining materiality upon the fact that the insiders were themselves influenced by K55-1 in purchasing large quantities of stock and calls. According to the dissent, the mere fact that the insiders were willing to risk their funds on the hope that future developments would be successful does not establish materiality.[65]

As for the stock option question, Judge Moore approved of the possible alternative suggested by the majority for future reference,[66] that insiders unable to disclose be free to accept options so long as they do not exercise them until after public disclosure of material information and subsequent ratification of the options.[67] Unlike the majority proponents of this alternative, however, the dissenters would have permitted the TGS insiders to invoke this defense even absent any showing that they could not reasonably have divulged the drilling results to the TGS option committee, or, as suggested by Judge Friendly,[68] merely advised them that the issuance of options was not then timely.[69]

Next, Judge Moore accused the majority of unjustifiably reversing Judge Bonsal's fact findings with respect to whether the first TGS press release was misleading because, in his view, a negative response to that question was implicit in Bonsal's finding that the release was not misleading on the basis of the facts known to the TGS draftsmen at the time of its preparation.[70] The dissent also pointed to the fact that the market price of TGS increased slightly on April 13, the day the release appeared in the financial media, as evidence of its non-pessimistic effect on the reasonable investor.[71] No consideration was given, however, to the subsequent market declines on April 14 and 15.

Finally, Judge Moore deplored the majority's interpretation[72] of the "in connection with" phrase of Rule 10b-5 as an unwarranted extension of congressional intent which would deter corporate dis-

---

64 *Id.* at 875-78 (Moore J., dissenting).

65 *Id.* at 876-77 (Moore J., dissenting).

66 *See id.* at 857 n.24.

67 *Id.* at 877-78 (Moore J., dissenting).

68 *See id.* at 867 (Friendly J., concurring).

69 *Id.* at 877-78 (Moore J., dissenting).

70 *Id.* at 880 (Moore J., dissenting).

71 *Id.*

72 *See id.* at 847.

closure.[73] Although he assumed TGS had not been negligent in issuing its first release for April 13 dissemination on the basis of April 10 drilling results,[74] Judge Moore further contended that merely negligent disclosures were intended to be regulated only by state law.[75] The protection against negligent misstatements afforded by section 18 of the Exchange Act and the Commission's power to enjoin repeatedly misleading releases were deemed sufficient protection for the investing public.[76]

II. Analysis

A. *Insiders*

On the facts of *Texas Gulf,* there was no disagreement on the Second Circuit as to whether the individual defendants could properly be termed "insiders" who are subject to Rule 10b-5. The claim that the Rule applied only to those subject to section 16 of the Exchange Act was summarily dismissed by Judge Bonsal, as well as the appellate court, in favor of first, an "access" test, derived from the Commission's 1961 decision in *Cady, Roberts*[77] and then a possession test.

In the context of proscribing the trading on inside information which occurred in *Texas Gulf,* the Second Circuit first defined the scope of Rule 10b-5 as applicable to "*anyone* who, *trading for his own account* in the securities of a corporation has 'access, directly or indirectly, to *information intended to be available only for a corporate purpose.*' "[78] (Emphasis supplied.) Clearly, however, the court had no intention of excluding from Rule 10b-5 persons who exploit material, undisclosed information without trading for their own accounts, for it held Darke, the TGS geologist, liable for a separate violation[79] of the Rule for having tipped. In addition, the above-quoted reference to information acquired only for a corporate purpose must be read in the context of the case wherein the inside information had in fact been obtained by TGS officers and employees for a corporate purpose and by virtue of their relation to the company. There obviously was no intention on the part of the ma-

73 *Id.* at 885-86 (Moore J., dissenting).

74 *Id.* at 881 (Moore J., dissenting).

75 *Id.* at 883 (Moore J., dissenting).

76 *Id.* at 885-86 (Moore J., dissenting).

77 *In re* Cady, Roberts & Co. 40 S.E.C. 907, 912 (1961).

78 401 F.2d at 848.

79 Darke had also been guilty of trading for his own account, both personally and through a nominee. *See id.* at 840-852.

jority to permit the advance use of otherwise material information obtained by persons not directly related to the company or for a non-corporate purpose. Thus, the court later declared that "*anyone in possession* of material inside information must either disclose it . . . or . . . abstain from trading in or recommending the securities concerned. . . ."[80] (Emphasis supplied.)

Although a Rule 10b-5 violation by Darke's tippees was only intimated,[81] it seems clear that tippees too, as persons "in possession of material inside information," are subject to the alternative duty of disclosure or abstention notwithstanding that they receive the information for no apparent corporate purpose.[82] Additional questions arise, however, as to whether persons who acquire material inside information by virtue of their connection with a corporation but for no legitimate corporate purpose, or persons unrelated to the company who receive inside information for some actual, prospective, or no corporate purpose, are either insiders or tippees, or both, within the purview of the Rule,[83] and the extent to which their conduct is or should be circumscribed. In some cases, the lack of relation to the company or the manner in which information is acquired will diminish the reliability of the information or preclude its verification or continued validity, but these factors can more appropriately be considered in determining whether the information is, under such circumstances, material.[84] Assuming materiality, however, the primary purpose of the Rule, *i.e.*, placing all investors on equal footing[85] and rewarding investment analysis and risk, suggests no basis for distinguishing between corporate managers, on the one hand, and on the other, a secretary, messenger or elevator operator employed

---

80 *Id.* at 848.

81 Albeit strongly. *Id.* at 852-53.

82 *See* Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). Also, it should be noted that since most "tippees" would be unauthorized and/or unable to effect disclosure, this duty would normally require total abstention from trading and recommending. For further discussion of problems relating to "tippees", *see* pp. 256-9, *infra.*

83 To the extent that varying duties and liabilities may be imposed on insiders or tippees, this classification may prove significant.

84 *See* pp. 242-56, *infra. But see* Note, *Texas Gulf Sulphur: Expanding Concepts of Corporate Disclosure Under SEC Rule 10b-5*, 43 ST. JOHN'S L. REV. 425, 436-37 (1969), to the effect that the touchstone of the Rule is the concept of "information-yielding relationships." If this be true, which we doubt, *see* text accompanying notes 87-95, *infra*, then courts and companies will be unnecessarily confronted with difficult classification problems in determining who has access to material inside information, *see id.*, when the crucial inquiry should be whether one who has acted actually *possessed* material inside information.

85 401 F.2d at 848, 851-852.

by a public company who overhears or intercepts undisclosed information about their or another company, or an accountant, lawyer, financial adviser, public relations agent, investment or commercial banker, underwriter, corporate trustee, registrar, transfer agent, customer, supplier, competitor or stockholder who may obtain such information in the course of an existing or prospective relationship with a company.

Although members of the latter group may lack a fiduciary duty to the particular company and members of the former group may have limited responsibilities commensurate with their functions, an insider's obligations need no longer depend upon the incidents of such a special relationship.[86] Rather, after *Texas Gulf*, such obligations derive from *a duty to the investing public*[87] which supersedes all other potentially conflicting private duties,[88] because uninformed investors are equally disadvantaged vis-à-vis non-fiduciaries or lower-echelon agents trading on material inside information as they would be with respect to trading by corporate managers, except to the extent that these "inner insiders" have still greater and at least superficially more reliable inside information than the aforementioned "outer insiders."[89] Nor can any general distinction between such

86 Misuse of material inside information obtained by virtue of a broker-dealer's "special relationship" as prospective underwriter and investment banker of the issuer was the Commission's basis for the violation charged after *Texas Gulf* in *In re* Van Alstyne, Noel & Co., CCH FED. SEC. L. REP. ¶ 77,656, at 83,433, 83,436 (S.E.A. Rel. No. 8511, Jan. 31, 1969). *See also In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., CCH FED. SEC. L. REP. ¶ 77,629 at 83,349 (S.E.A. Rel. No. 8459, Nov. 25, 1968), [hereinafter cited as Merrill Lynch] ("business relationship"); Note, *supra*, note 84, 43 ST. JOHN'S L. REV. at 436-37 ("special relationships").

87 *See* 401 F.2d at 848, where Judge Waterman declared that "the Rule is based in policy on the justifiable expectation of the securities market place that all investors trading on impersonal exchange have relatively equal access to material information. . . ." *See also* Remarks of S.E.C. Solicitor David E. Ferber, Transcript of Practising Law Institute Panel on Texas Gulf Sulphur, Oct. 1968, at 235 (hereinafter cited as PLI TRANSCRIPT).

88 *See, e.g.*, Merrill Lynch note 86 *supra*, in which the Commission's charge was based on a brokerage firm's passing material inside information concerning a substantial earnings decline of a company which had previously been recommended by the firm to certain of its customers, notwithstanding its private fiduciary duty to act for their benefit. It was noted that the violation would not have been cured if the information had been given to all of the firm's customers because it would have been unfair to the remainder of the investing public. *Id.* at 83,349-50 n.8.

89 It is not intended to ignore the likelihood that corporate managers generally have more detailed and reliable material undisclosed information than others whose relation to the company is less intimate or who acquire information fortuitously. In fact, this premise is basic to the presumptions underlying section 16(b) of the Ex-

classes of insiders be drawn in terms of their relative capacity to comply with the mandate of the Rule for all that is required is abstention until the information becomes publicly available and anyone may be able to ascertain such availability to the extent that he can obtain an up-to-date report on the particular security from a broker or by following the financial media.[90]

In this view, it is not by inadvertence that we find in Judge Waterman's opinion, in addition to an exposition of the "access" delineation of insiders as specifically applied to the TGS insiders, a broader definition of "insider" drawn to include "anyone in possession of material, inside information."[91] The point is that *anyone* who at any time *possesses* material, undisclosed information can take advantage of it at the expense of the uninformed public, irrespective of his relation to the company or his general *access* to such information, and should, therefore, be subject to Rule 10b-5.[92] While there are valid reasons for permitting certain corporate officials[93] and perhaps some outsiders[94] advance access to material inside informa-

---

change Act. Rather, all that is suggested herein is that differences in relative access to inside information can best be treated more consistently with the design of Rule 10b-5, on an individual basis in terms of materiality.

90 With respect to relative capacities to determine materiality of information, a rule of thumb implicit in *Texas Gulf*, which can be followed by even an uneducated lower-level employee, is that if information is sufficiently important to induce an immediate investment decision by an "outer" or "inner" insider, it is sufficiently likely to be material to require abstention or disclosure. *See* Henderson, PLI TRANSCRIPT, *supra* note 87, at 165. Clearly, such employees will not divine rules of safe conduct from reading the *Texas Gulf* opinion or this article; a major educational effort will be required of public corporations, banks, brokerage firms and other businesses which deal with inside information.

91 *See* text accompanying notes 78-80, *supra*.

92 The authors believe that this is, and should be, the law as a matter of policy, while fully recognizing the present difficulty, if not impossibility, of proof and enforcement in many instances. The applicability of this policy analysis to tippees is discussed at pp. 256-9, *infra*.

93 For example, members of a corporation's stock option committee should probably be advised previously of undisclosed significant corporate development not yet ripe for public release, if necessary to prevent the granting of options at prices which do not fairly reflect the value of the corporation's stock. *See* 401 F.2d at 865 (Friendly, J., concurring).

94 Professor Mundheim has suggested the doubtful proposition that security analysts should not be treated as insiders because they perform a useful function in disseminating and analyzing investment information. Digest of Panel Discussion on "What Is Proper Information for Security Analysts?" before New York Society of Security Analysts, Inc., Nov. 12, 1968, pp. 6-7 (hereinafter cited as NYSSA DIGEST). A complete transcript of the panel proceedings is available at the library of the Society.

tion, there can be no justification for allowing any of them to profit at the public's expense.[95]

B. *Materiality*

1. The Applicable Standard

Perhaps the single most significant portion of the *Texas Gulf* opinion, and that which has been most disturbing to the investment community[96] and commentators,[97] is its discussion of materiality. On the facts presented to the court, its holding as to materiality should hardly have been surprising, in view of the obvious importance attached to even one successful drill core, by many traders in the "speculative sixties."[98] In fact, the hue and cry generated by this part of the decision seems to be attributable to a failure to read the court's supposedly disparate statements on materiality in the context of the several objectives apparently sought to be accomplished by the opinion, *i.e.*, refuting the arguments of the defendants and the district court, restating the general rule applicable to non-disclosure cases consistent with prior authorities, issuing safe guidelines for insiders' individual actions, and suggesting, in the absence of Commission regulation, standards for corporate disclosure.

Judge Moore's dissent appears to stem from a confusion of the latter two purposes and an unwarranted amalgamation of the dual alternative duties of disclosure or abstention established in *Cady, Roberts*.[99] The dissenters' principal complaint against the majority view of materiality was that the information as to K55-1 was not ripe for public disclosure.[100] However valid may be the reasons for non-disclosure of drilling progress at such an early stage of development,[101] and the majority expressly reserved resolution of the tim-

95 *See* Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur*, 28 MD. L. REV. 189, 221, 223 (1968), proposing that security analysts be accorded a preferred status in obtaining undisclosed corporate data (except predictions of corporate earnings) if, and only if, they are willing to make their reports available to the public.

96 Wall St. Journal, Nov. 14, 1968, at 3, col. 2 & 3.

97 *See* Remarks of Professor Bromberg, PLI TRANSCRIPT, *supra* note 87, at 204-05.

98 See 401 F.2d at 850-51, where the court considered the testimony of a mining stock specialist to the effect that completion of the first hole, especially one as rich and long as K55-1, was " 'very, very significant' " and that "it 'is a natural thing to buy more stock once they give you the first drill hole.' "

99 40 S.E.C. 907, 911-12 (1961).

100 401 F.2d at 873.

101 It should, however, be noted that, if TGS had otherwise been willing to divulge the results of K55-1, there should have been no reason why it could not have

ing of disclosure to business judgment, the Commission and the exchanges,[102] it does not then follow, *a fortiori*, that insiders may nonetheless reap an advantage *at the expense of the uninformed public.*[103] The unarticulated premise in the dissent's position is that insiders should always be as free to trade in their companies' securities as members of the public, however uninformed, else any restrictions on their freedom will deter them from serving the corporate world that urgently requires their assistance.[104] This is, however, a matter of policy on which Congress has unequivocally taken the contrary position,[105] for reasons which are as persuasive today as they were in 1934.[106] Similarly, Judge Moore's disagreement as to the impact of K55-1 on the reasonable investor, *i.e.*, that it could not be material because "one drill hole does not reveal a commercially profitable mine" and only mining engineers would have valued the assay of K55-1,[107] ignores the thrust of the majority's position and manifests the type of naiveté of which he later accuses his brethren.[108] Obvi-

---

fully reported the basic facts so long as it disclaimed any premature conclusions or predictions.

102 401 F.2d at 850 n.12.

103 For an extremely effective statement of the case against insider trading, *see* Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1438-57 (1967).

104 This is apparently the view of at least one commentator. *See* H. Manne, *Insider Trading and the Stock Market* (1966) *(passim)*.

105 *See* 401 F.2d at 848 n.9, and authorities cited therein. Certainly, if Congress had been willing to permit insider trading, it would not have enacted section 16(b) of the Exchange Act, 15 U.S.C. § 78p (b). The authors recognize that it is *trading* that is condemned in § 16(b), *i.e., short-term purchases and sales in any combination,* and that the argument may be made that purchases by insiders, standing alone, are not contrary to the policy expressed in § 16(b) or any other policy expressly articulated in the Exchange Act. It is, nevertheless, clear to the authors that the *use* in any one transaction of information fortuitously learned and not generally available is unfair to others (and the purchases by the informed TGS insiders was certainly unfair to the uninformed sellers who sold at an artificially low price) and is therefore a wrong, which the overall investor protection principle underlying the Exchange Act must embrace as a form of prohibited conduct.

106 As noted by the majority, insider trading profits "are forms of secret corporate compensation . . . derived at the expense of the uninformed investing public and it is not at the expense of the corporation which receives the sole benefit from insider incentives." 401 F.2d at 851. It has also been observed that "[i]f insiders are free to trade on undisclosed, material information, they are subject to a conflict of interest that may affect their judgment not only in the timing of disclosure, but also in the timing of the underlying events themselves." Schotland, *supra* note 103.

107 401 F.2d at 875.

108 *See id.* at 888-89.

ously, the mere *possibility* of a commercially profitable mine could have influenced reasonable, if speculative, investors to buy TGS stock[109] and, if so, any subsequent disclosure of such possibility would have increased the market price and enabled insiders to profit unfairly.

The dissenters' final point of contention regarding materiality was the majority's purported adoption of a subjective standard which necessarily appraised the facts as they existed at any given time with the aid of hindsight.[110] However, in accusing the majority of confusing the insiders' motives with knowledge of material information, Judge Moore not only failed to propose more objective criteria in cases like *Texas Gulf* where actual market changes were unavailable;[111] significantly, he also ignored the expert[112] testimony indicating the importance of K55-1 as well as the strong inferences flowing from the fact that not one, *but nearly all,* of the insiders had engaged in securities transactions, some of them quite speculative and for the short-term, after learning of K55-1. Surely, it was not totally unreasonable for the majority to have preferred to treat such facts as more than mere coincidence rather than making the unsupportable presumption that none of the insiders could be deemed to have acted as a reasonable investor.

The remaining difficulties with the majority's discussion of materiality derive from its inclusion of supposedly variant standards which have collectively been interpreted as establishing an impracticably low "threshold of materiality."[113] The opinion first declared that Rule 10b-5 was applicable

---

109 *See id.* at 849-50.

110 *Id.* at 876-77.

111 Note, *supra* note 85, 43 ST. JOHN'S L. REV. at 447. *Compare In re* Van Alstyne, Noel & Co., *supra* note 86, at 83,435 n.7, where the precise information acted upon by insiders was subsequently disclosed, thereby permitting the use of market reaction to confirm materiality.

112 *See* note 98, *supra*. Other objective evidence of nonmateriality of an expert nature would be the financial media's refusal to publish the information in question. *See* Ferber, PLI TRANSCRIPT, *supra* note 87, at 238. This refusal would not, of course, be conclusive and a concerned company might consider taking an advertisement in the newspaper most relevant to the company and advising all brokers dealing in the stock of the development. In this situation, SEC Solicitor Ferber was reported to have suggested a mailing to shareholders, N. Y. Times, Sept. 12, 1968, p. 77, col. 3, but if the information were material, such selective disclosure might aggravate the problem. *Cf. In re* Merrill Lynch, *supra* note 86, at 83, 349-50 n.8.

113 *See* Bromberg, PLI TRANSCRIPT, *supra*, note 87, at 204-05.

> only in 'those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if . . . disclosed.'[114]

The court then appeared to invoke a broader definition in terms of

> 'any fact . . . which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities.'[115]

The basic test of materiality was generally restated from *List v. Fashion Park, Inc.*,[116] as

> 'whether a reasonable man would attach importance [to the particular information] in determining his choice of action in the transaction in question.'[117]

Concluding that speculators were not *per se* excluded from the class of reasonable investors entitled to information important to their investment decisions, the court emphasized that

> material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell or hold the company's securities.[118]

Finally, with respect to corporate developments not yet completed

---

114 401 F.2d at 848, *quoting from* Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965).

115 401 F.2d at 849, *quoting from*, List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1964), *cert. denied, sub nom.* List v. Lerner, 382 U.S. 811 (1965); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963).

116 List v. Fashion Park, 340 F.2d 457 (2d Cir. 1965).

117 340 F.2d at 462, adopted by TGS court 401 F.2d at 849.

118 401 F.2d at 849. An interesting case of undisclosed information significant to both the intrinsic value of the corporation's stock and to the desire of investors was presented in SEC v. Great American Industries, Inc. CCH FED. SEC. L. REP. ¶ 92,325 (2d Cir. No. 31010, Dec. 23, 1968) where the Commission obtained injunctive relief under Rule 10b-5 for a company's failure to disclose (in its press releases and Form 8K), or even ascertain the fact, that approximately two-thirds of the consideration paid by it in stock for certain real estate was to be paid to finders. Such a fact was material because a prospective purchaser of the company's stock might reasonably doubt that the property was worth the price paid, *id.* at 97,540, and thereby question the underlying asset value of the stock. Also, such a fact would most probably affect an investor's confidence in management, a factor more directed to investors' desire for the stock. *See also* Hendricks v. Flato Realty Investments, CCH FED. SEC. L. REP. ¶ 92,290 (S.D.Tex. No. C.A. 67C-92 September 9, 1968), where the information material to the plaintiff concerned the willingness of other reputable businessmen to accept stock of a company in exchange for certain well-known properties, *id.* at 97,387.

or of indefinite magnitude, the court instructed that materiality in each case

> will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity . . .[119]

It is submitted that, taken in the context of the arguments presented to the court and its various purposes, these statements are neither mutually exclusive, disparate nor impracticable. Furthermore, in an area as vast and variant as materiality, it would require articulative powers unknown to both the bar and to the bench to expect single-sentence statements of all-embracing scope and clarity.

The basic standard incorporating the hypothetical reasonable investor presents no conceptual novelty since it has long been used in common law cases[120] and has undoubtedly been a major criterion employed by the Commission in ascertaining the materiality of statements required in documents filed with it. Likewise, the express inclusion within the concept of materiality of facts which affect a corporation's future or the desire of other investors to buy, sell or hold its stock was no great departure from prior understanding[121] for such items, which may have greater importance to speculative than conservative investors, have been consistently required disclosures under Commission and exchange rules.[122] The balancing test pro-

---

119 401 F.2d at 849.

120 *See* RESTATEMENT, TORTS, § 532(a) (1938); HARPER & JAMES, TORTS, 565-66 (1st ed. 1956). Learned treatises notwithstanding, the authors recognize the practical, as contrasted with conceptual, difficulty of this determination. A professional broker may assert with no little persuasion that the "reasonable investor" is as rare as human perfection. If so, *a fortiorari,* the need for the *Texas Gulf* type results.

121 *Cf.* SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), finding trading by an investment adviser based upon its knowledge that its subsequently disseminated investment reports would influence advisees to be fraudulent practice under Section 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1965), the language of which is, in part, virtually identical to that of Rule 10b-5.

122 *See* item 1(a) of Form 8-K, 2 CCH FED. SEC. L. REP. ¶ 31,003, requiring disclosure of changes in control, item 6 of Form 10-K, 2 CCH FED. SEC. L. REP. ¶ 31,103, requiring disclosure of the background of directors, and item 16 of Form S-1, 1 CCH FED. SEC. L. REP. ¶ 7123, requiring background of executive officers and directors. *See also* NEW YORK STOCK EXCHANGE COMPANY MANUAL A-22 (July 1968), listing stocks splits, news of major new products, contract awards, discoveries and expansion plans among information which should be immediately released to the public. It is also expressly contemplated that announcements of preliminary developments may be necessary, presumably because they are "material notwithstanding their indefiniteness." *Id.* at A-19.

posed by Judge Waterman was no more than an articulation of the considerations to be employed by a reasonable investor in determining the investment action, if any, to be taken on the basis of knowledge of a corporate development which has not yet occurred or the magnitude of which is not yet ascertainable, and seems sufficiently flexible to withstand substantial criticism.[123]

The statement that material developments will be "essentially extraordinary" and "reasonably certain to have a substantial effect on the market price" is a valuable qualification of the foregoing standards which assumes, quite properly, that the reasonable, if speculative, investor will not take immediate investment action[124] after utilizing the balancing process upon learning, *e.g.*, of a normal corporate development which has been readily anticipated or discounted by the majority of reasonable investors in the security; if such a common development were to substantially influence an investor, perhaps because he had previously been unfamiliar with the company, the industry or the market generally or because he placed unique value on such an event, he would fall without the class of reasonable investors. In effect, it is this latter qualification

---

[123] *See* Wiesen, *Disclosure of Inside Information—Materiality And Texas Gulf Sulphur*, 28 MD. L. REV. 189, 207 (1968).

[124] It should be noted that absent such immediate action by the many reasonable investors, disclosure of information would not *substantially* affect the market price of a security. Conversely, immediate action would not be reasonable if no such substantial effect on the market price were to result from disclosure for such lack of effect would indicate that most reasonable investors did not consider the information significant.

SEC General Counsel, Philip A. Loomis, has incorporated this concept in his definition of materiality, given to the Financial Analysts Federation Fall Conference on Oct. 7, 1968, CCH FED. SEC. L. REP. ¶ 77,624 (hereinafter cited as FAF DIGEST), by requiring information to be of a sort which would have a "substantial and immediate" impact on the market price of a security, *i.e.*, a price change within a trading day or two after dissemination which would perceptibly exceed the security's day-to-day or week-to-week trading norms. *See also* Henderson, PLI TRANSCRIPT, *supra* note 87, at 168: "the common sense way of phrasing the test is, if the fellow hearing the news... figures he had better act on it right now or before tomorrow morning, surely it's material." *But see* Ferber, NYSSA DIGEST, *supra* note 94, at 5, to the effect that the "substantial effect required by the *Texas Gulf* definition of materiality may be either long or short-term. It is interesting to note that Mr. Ferber had, one month earlier, expressed his agreement with Mr. Loomis' "immediate and substantial" terminology. *See* PLI TRANSCRIPT, *supra*, note 87, at 314. That projections of *future* sales, cash flow, earnings and acquisitions may be material, presumably because they would have an immediate market impact if substantially different from public understanding, *see* SEC v. Glen Alden Corp., CCH FED. SEC. L. REP. ¶ 92,280 (S.D.N.Y. No. 68 Civ. 3203, Aug. 7, 1968).

which ensures that public corporations and the financial media, as well as reasonable investors, will not be unnecessarily imposed upon by the required dissemination of trivia.[125]

It should, however, be noted that events which are "essentially extraordinary" in respect of one corporation may not be so for another. For example, news of acquisitions and offers thereof may be considered more common for the group of aggressive, growth-oriented conglomerates than for already huge old-line companies which have resisted diversification and external expansion, though they will still usually be essentially extraordinary in terms of market impact. Similarly, new product developments and discoveries of new resources are more usual in certain industries than in others. To the extent that the market price of a company's securities may already have substantially discounted generally anticipated developments regarding the company which would, for most companies, be "essentially extraordinary," disclosure of such developments may not have the requisite "substantial effect" on the market price because reasonable investors might not be motivated into immediate action. In this event, which would appear to be a rarity, there may be no inherent unfairness, or at least no demonstrable proof thereof, in permitting insiders to trade. Thus, the "essentially extraordinary" requirement should be determined by reference to the particular company concerned, in much the same manner and for the same purpose as the "anticipated magnitude" of an event is assessed, *i.e.*, to ascertain whether disclosure would have the substantial market impact without which there is little, if any, justification for prohibiting insider trading.[126]

Similarly, the reasonable investor's reaction is the focal point

---

125 This qualification of the more general definitional statements of materiality has been seized upon by most courts and commentators treating the subject as the true "rule of the case." *See, e.g.*, Britt v. The Cyril Bath Co., CCH FED. SEC. L. REP. 92,267 (N.D. Ohio, No. C 67-717, Sept. 16, 1968); Loomis, FAF DIGEST *supra* note 124; Remarks of Kenneth J. Bialkin, PLI TRANSCRIPT, *supra* note 87, at 139; Remarks of SEC Solicitor David E. Ferber, *id.* at 228-29; Ferber, NYSSA DIGEST, *supra* note 94 at 5. *See also* Remarks of SEC Chairman Hamer H. Budge, then a Commission member, but not Chairman, before New York Chapter of American Society of Corporate Secretaries, Nov. 18, 1965, quoted in Wiesen, *supra* note 123, at 206; Cary, *Symposium: Insider Trading In Stocks*, 21 BUS. LAW. 1009, 1014 (1966).

126 *See* text accompanying notes 124 and 125, *supra*. A blanket prohibition against insider trading without any objective likelihood of materiality would effectively preclude the use of perceptive analysis and "educated" guesses, which *Texas Gulf* sought to preserve, *see* 401 F.2d at 848-49, and deprive them and their companies of the valuable incentives derived from legitimate investments.

in determining materiality, not only because he is within the class sought to be protected by the Rule, but also because his reaction will produce the requisite market impact which justifies insider restrictions. For this reason, the class of reasonable investors should be defined for materiality purposes to include both the average small investor, whose collective action will substantially affect the market, and any sizable group of sophisticated or professional investors whose trading volume will likewise affect the market. Information which would influence either class of investors will, when disclosed, cause the market to rise or fall, as the case may be, and provide insiders with their unfair profit.

The sole remaining statement of the majority as to materiality, *i.e.*, facts are material if, in "reasonable and objective contemplation," they "*might* affect the value of the corporation's stock or securities," (Emphasis supplied as before) can and should be construed on several different levels. Analytically, it is a further confirmation of the court's adherence to the concept of the reasonable investor. Thus, it is also a clear indication of the adoption, to the extent possible in each case, of an objective standard of materiality within which a particular investor's unique motivation will be substantially disregarded in favor of the reactions of a class of presumably reasonable investors, as confirmed by those of expert investment analysts and advisers.

Next, this pejorative language of the court must be read on a first level in the context of the defendants' and Judge Bonsal's contention that materiality should be determined by reference to the prudent investor, whose sole concern was with events which affect a security's intrinsic value. In this view, the court was merely emphasizing, consistently with its rejection of the restrictive concept of the prudent investor, which is a trustee's test, not a securities law test, that information could be material, *i.e.*, sufficiently important to influence the market and permit insider exploitation, even if its effect on a security's *underlying* value was not certain, but merely possible, as was the case in *Texas Gulf*.[127]

On a second level, however, the court may also have been instructing insiders to exercise great caution in their use of corporate information. In other words, when the effect of disclosure of a par-

127 This was undoubtedly the primary meaning intended by the court in uttering its pejorative language, notably without reference to the effect of such information on the *market* value of the security if *disclosed*, virtually in the same breath as its prior reference to *essentially extraordinary* information *reasonably certain* to have a *substantial effect* on the *market price* of the security if *disclosed*.

ticular development on the *market* value of a security cannot be predicted with certainty, but *may* be substantial, insiders would be well-advised to forego investment action until disclosure. As insiders' transactions may themselves permit an inference of materiality, such advice appears to be quite sound. Indeed, the court's holding that Kline and Huntington, neither of whom had detailed knowledge of the drilling, possessed material information seems to verify the application of a stricter standard to insiders.[128]

Moreover, in view of the various legitimate reasons for non-disclosure of *preliminary* developments such as a potential ore strike or acquisition but the absence of any justification for insider investment activity, the court, on yet a third level, may even have been suggesting a more stringent materiality test for insider activity than for the timing of affirmative disclosure. It is certainly arguable that although insiders might be so familiar with a company and the market for its securities that a relatively normal development which may not be "reasonably certain to have a substantial effect on the market price" may nevertheless yield them an unfair investment advantage and require their abstention, the company need not disclose such events not "essentially extraordinary in nature" which would be insignificant to the reasonable investor.[129]

2. Extrinsic Components of Materiality

Certain additional materiality problems not clearly presented in *Texas Gulf* may also be resolved by reference to the standards suggested in the opinion. First, there is the question of how specific information must be in order to be termed material and activate the obligations of Rule 10b-5. Intimately related to this issue is the problem of reliability of information which will commonly arise in the case of one who becomes an "insider" by his fortuitous receipt and possession of information but lacks a relationship yielding access to such data or has not obtained it for a corporate purpose. Both specificity and reliability, hence materiality, are likely to be diminished in direct proportion to the distance between the recipient of information and its initial source.[130] In addition, the knowledge of the recipient that the information in the form received, however vague, derives from an authoritative source may itself be material insofar

128 *See* text accompanying notes 132-34, *infra.*

129 The unfair advantage in this context might derive not from the expert analysis expressly sanctioned by *Texas Gulf*, but from an insider's knowledge of several facts which, only in combination, would influence the reasonable investor upon disclosure.

130 *See* Bromberg, PLI TRANSCRIPT, *supra* note 87, at 208-09.

as it assures reliability.[131] All of these factors must be thrown onto the scales in performing the balancing test formulated by *Texas* Gulf to discount the investment value of either or both basic factors, *i.e.*, indicated probability that an event will occur or its anticipated magnitude, to which the inside information relates.

This balancing exercise in *Texas Gulf* yielded a finding of materiality as to defendants Huntington and Kline but not as to Murray, though none of them had detailed knowledge of the drilling progress at the time of his transaction in TGS stock. Huntington, a TGS attorney who participated in the Kidd land acquisition, appears to have been held for acting upon material information as a result of judicial inferences drawn from his proximity[132] to TGS officials who knew all about K55-1 and his purchase, unusual for him, of short-term calls on the same day that he had prepared a substantial written offer by TGS for the Kidd property. The court apparently felt that reliable, albeit non-detailed, knowledge of "the highly favorable nature of preliminary operations" was material,[133] in view of the great magnitude of any resulting strike and of the tremendous impact which such general knowledge had on Huntington, a presumably reasonable investor, in inducing him to purchase calls for the first time. Kline was held to have violated Rule 10b-5 by accepting stock options under less auspicious circumstances presumably because he had been TGS's secretary, and later a vice-president and its general counsel, although he had known only that K55-1 had intersected a sulphide body containing copper and zinc and that TGS sought to acquire the Kidd parcel.[134] Murray's relation to the knowledgeable insiders, the extent of his general knowledge of K55-1 and the nature of his transactions were not discussed by the court in affirming dismissal of the charges against him.[135] Thus, it appears that lack of specific information will not preclude a finding of materiality as to "inner insiders," at least when their general knowledge is highly reliable and the prospective magnitude of the particular development is great.

The notion of reliability poses special problems in terms of materiality. Suppose, for example, that a low-level company or brokerage firm employee receives specific information concerning an event

131 *Cf. id.* at 210.

132 The court notes that Huntington's general understanding of the situation was "probably reliable." 401 F.2d at 583.

133 *Id.*

134 *Id.* at 857 n.24.

135 *Id.* at 852 n.14.

of great magnitude vis-à-vis the company concerned, but has no knowledge as to its reliability because he is unable reasonably to determine its initial source.[136] In similar circumstances, it has been generally suggested that he may trade without restriction.[137] This resolution seems, at first, correct for most cases since the reasonable, if speculative, investor would not normally take immediate investment action on such a basis in a market in which unreliable rumors are rampant and, further, because enforcement of Rule 10b-5 in such cases would, under present circumstances, necessarily be either impractical or so piecemeal as to border on injustice. It might also be argued, though not, in our judgment, persuasively, that to render transactions on such bases unlawful would create an uncertainty which would unduly disturb the current standards of the securities marketplace.

In response to these latter points, however, it should be observed that legitimate market interest is likely, in the long run, to be deterred by in any way encouraging reliance, particularly by the irregular or small investor, upon unreliable information and that any market standard which condones unfairness demands change. The enforcement problem cannot realistically be ignored but its solution demands, not a relaxation of otherwise indicated standards, but administrative improvement.

Nor should it be summarily assumed that a reasonable speculator would never act upon such information without some knowledge of the source. If the magnitude of the event on which he has detailed information is sufficiently great, the event is not of the sort subject to rapid change, and the market has not already discounted some close version of his information, he, like the TGS insiders, takes little, if any, risk in acting (particularly if he deals in options)

---

136 This, of course, excludes the case where the recipient of information has no assurance that the ultimate source of his information is official but knows that his source is generally reliable and likely to possess some direct or indirect connection to an official source, in which case there would be some degree of reliability perhaps sufficient to prompt a reasonable speculator into action.

137 SEC General Counsel Loomis is reported to have stated that a security analyst who receives information "second-hand and has no reason to believe that his informant was . . . breaching any duty by making such a disclosure," the analyst was "home free." *See* FAF DIGEST, *supra* note 124. However, if the informant were a generally reliable source, the recipient should be on notice that someone in the chain of communication was breaching a duty and, furthermore, assuming reliability, he and all who passed the information would be violating their public duty. Moreover, even accidentally received information may be reliable and, if so, highly material. *See* Meeker, PLI TRANSCRIPT, *supra* note 87, at 321.

and may stand to gain a great deal. The risk is greater, but still tolerable, if the event is subject to fluctuation so long as the market has clearly not discounted the event. If, on the other hand, the market price already reflects some approximation of the event in question, the risk of loss is probably too great for a reasonable speculator, even in the case of an event which requires no further development or finalization. In the above situations, where the reasonable speculator would take immediate action on specific but unreliable (particularly in the sense of unconfirmable) information, it is submitted that the "equal footing" and "fundamental fairness" rationales of *Texas Gulf* require a finding of materiality as a predicate for imposing the Rule 10b-5 duty of abstention. Of course, if the information is neither specific nor reliable, it would clearly not be material.

3. Externally Generated Information

One particularly troublesome category of information, which may be material if specific and reliable to the extent previously noted, is that of "market" information, *i.e.*, information about a company or the desire of other investors for its securities which is generated externally and has no initial company source. At least one commentator has apparently taken the position that such information should not be within the scope of Rule 10b-5,[138] but others have counseled caution.[139] Indeed, in view of the express inclusion in *Texas Gulf* of information which affects the desire of other investors for the stock[140] and the court's primary concern with preventing some investors from profiting by subsequent substantial price changes solely by virtue of their possession of factual information unavailable to others, some market information seems clearly material and, if unavailable[141] to the investing public,[142] should not be acted upon.

138 Bromberg, PLI TRANSCRIPT, *supra* note 87, at 323: "You get entirely out of the category of *inside* information to the extent that its not from the company." (emphasis supplied.) In all fairness to Professor Bromberg, the above statement may have been intended to exclude from the strictures of the Rule only information which is publicly available and, therefore, not "inside." Such information may indeed be material but its private use does not violate the Rule's precept of "fundamental fairness" to the extent that all enterprising investors have equal access to it.

139 *See* Ferber, PLI TRANSCRIPT, *supra* note 87, at 235; Meeker, PLI TRANSCRIPT, *supra* note 87, at 320.

140 *See* note 118, *supra* and accompanying text.

141 In many, if not all, market information cases, neither the recipient nor the source will be in a position to disclose their knowledge to the public. However, in view of the assertion in *Texas Gulf* that "[t]he only regulatory objective is that *access* to material information be enjoyed equally . . . ," 401 F.2d at 849 (emphasis supplied),

One common example of market information is knowledge of an impending tender offer by one company for the publicly traded shares of another; such information is clearly material to the value of the latter company's stock. Similarly, a proposed merger or acquisition of substantially all of the assets of a public company results in an offer, in essence, to purchase the merged or acquired company's shares and can significantly affect the value of such shares. Such information is unquestionably material, whether or not derived from company sources, and, if sufficiently specific[143] and reliable,[144] should not be utilized until publicly disclosed.[145]

---

and the court's approval of the use of "financial or expert analysis" and "evaluative expertise," *id.* at 848-49, it would seem sufficient that the information be publicly available though not formally disclosed. Much of this information, *e.g.*, insider transactions reported on SEC Form 4 pursuant to section 16(a) of the Exchange Act of trading volume in listed securities, is available through the financial media and a large part of the remainder can be obtained through brokers.

142 It is not intended to deny to expert insiders or perceptive outsiders the benefit of their superior analyses. *See* Cady, Roberts, *supra* note 77; Texas Gulf, 401 F.2d at 848-49.

143 The history of tender or exchange offers, special bids, and perhaps to a somewhat lesser extent, merger and acquisition bids, suggest that such proposals usually offer cash or securities exceeding the then current market value of the shares to be acquired or liquidated. Thus, a much lower level of specificity would be required by the reasonable, if speculative, investor before taking action. Furthermore, the great magnitude in terms of market impact of developments such as tender offers may indicate that mere knowledge of the *possibility* of a tender, as might, *e.g.*, be possessed by a broker engaged in a massive, short-term purchase program for a customer, may be material. Of course, to the extent that such a program is reasonably likely to affect the market for a security, knowledge thereof is itself material.

144 In this context, the initial or official source of the information would be the acquiring company and any informant reasonably connected thereto, *e.g.*, the dealer-manager of an offeror or one learning of the offer from him, could be considered reliable.

145 Such information is not usually publicly available until after disclosure though it may be given privately to certain brokers and institutional investors. Senate Antitrust and Monopoly Committee Chief Counsel Jerry Cohen and Chairman Marvin Finell of Great American Industries, Inc. are reported to have said that selective disclosure by brokers to certain institutional investors in order to induce their purchasing stock and then tendering, a practice known as "warehousing" desired securities into friendly hands, was improper. N. Y. Times, Mar. 6, 1969, at 59, col. 8 (city ed.). However, it must be observed that the public is no more injured by this practice than if the acquiring company had borrowed the funds to make such purchases for its own account or if, as is commonly done, a broker is employed to buy up all available shares for a stated profit. Since such institutions or brokers may be deemed agents of the acquiring company, which is not required by Rule 10b-5 to disclose its intentions prior to making its offer, see General Time Corp. v. Talley Industries, Inc., CCH FED. SEC. L. REP. ¶ 92,291 at 97,394 (2d Cir. Nos. 32299 & 32300, Oct. 23, 1968), if full

The interpretive judicial development of Rule 10b-5 could ultimately embrace externally generated information concerning an issuer,[146] and other information concerning an issuer can be relevant to an alert investing public. The latter category could include changes in management[147] or its fitness,[148] the identity of other investors purchasing large quantities of the issuer's securities[149] and even an impending investment advisory service recommendation.[150] Such judicial development may also encompass advance information as to unusual trading volume or availability of securities for trading,[151] particularly if there are allegations of a breach of

disclosure of their acts in behalf of their principal is made pursuant to Sections 13 and 14 of the Exchange Act and the Commission's rules thereunder, no violation of Rule 10b-5 would seem warranted.

146 *See* Meeker, PLI TRANSCRIPT, *supra* note 87, at 320.

147 For example, the market price of Hygrade Food Products Corporation common stock on the American Stock Exhange increased from 42¾ to 75⅝ in the space of a few weeks primarily as a result of the announcement on December 5, 1968 that the controlling shares had been sold to Beck Industries, whose principals had established a reputation for capital growth. *See* Wall Street Journal, Dec. 5, 1968, at 5, col. 2.

148 *Cf.* SEC v. Great American Industries, Inc., *supra* note 117, where it was held material to stockholders of a corporation that two-thirds of the aggregate consideration received by the company for certain real estate were paid by the seller as finders' fees.

149 *See, e.g.*, Hendricks v. Flato Realty Investments, *supra* note 117 (by implication). The mere fact that an insider is on the other end of the transaction is not, however, material in itself. *See, e.g.*, List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1964), *cert. denied sub nom*, List v. Lerner, 382 U.S. 811 (1965); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967); 3 L. Loss, SECURITIES REGULATION 1465 (2d ed. 1961). Knowledge of substantial insider transactions may, however, be important to a speculator, though perhaps an unreasonable one, and, in addition, may indicate a change in management's interest in and control of the company.

150 *Cf.* SEC v. Capital Gains Research Bureau, Inc., *supra* note 120 (by implication).

151 Great potential abuse is inherent in a market-maker's unique knowledge of the trading volume in an unlisted security for his "spread," which results in profits to him in dealing for his own account, is determined by him and subject only to relatively flexible regulation by the N.A.S.D. See Art. I, §§ 1 and 4 of the N.A.S.D. Rules of Fair Practice, CCH N.A.S.D. [MANUAL] ¶ 2154.§4 merely requires members to buy or sell for their own account at prices which are "fair, taking into consideration . . . market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that [they are] entitled to a profit . . . ," which policy has been interpreted as requiring a reasonable relation between the dealer's price and the current market price, which may, if he is the only dealer in the security, be determined by him. The 5% mark-up guide-line may fluctuate depending on the type and price of the security, its availability, the size of the transaction and services furnished by the dealer. *Id.* at 2056-57. Enforcement of these rules has necessarily been limited to extreme cases. *See, e.g.*, Merritt, Vickers, Inc. v. S.E.C., 352

duty by a stock exchange specialist, an over-the-counter market maker or a stock transfer agent. Furthermore, it is plain that institutional brokers would be well-advised to treat confidentially their information as to the entry or exit of mutual funds or other institutional investors or block traders into or from the market.[152]

4. A Proposed Definition

To summarize the foregoing the following definition is proposed.

> Information is material when:
> (1) It concerns an essentially extraordinary development as to the corporation or the market for its security which
> (2) can, if disclosed, reasonably be expected to affect, within a short period of time, the market price of the security in excess of the normal price fluctuation of such security. Such an effect can reasonably be expected to occur if the particular development is of a magnitude, discounted
> (a) in the case of an incomplete development, by its improbability of occurrence;
> (b) by any lack of specificity of the information; and
> (c) by the degree of its unreliability, sufficiently great, in the context of other publicly available information about the company or its securities, to prompt a reasonable, if speculative, investor to take immediate action.

C. *Tipping*

It has already been suggested that those who acquire material undisclosed information for no legitimate corporate purpose or not by virtue of their relationship to a company, the so-called "outer insiders" or "tippees,"[153] should be equally restricted by Rule 10b-5

F.2d 293(2d Cir. 1965) *aff'g*, S.E.A. Release No. 7409 (Sept. 2, 1964) (N.A.S.D. disciplinary action upheld); In re J. A. Winston & Co., Inc., S.E.A. Release No. 7334 (June 5, 1964) (same). Consistent enforcement of a "spread" limitation would considerably diminish a dealer's opportunity to profit by inside market information but a less restrictive alternative would be to require the publication in the "pink sheets" of daily volume and price fluctuation in over-the-counter securities. This could enable non-market-making dealers and others aware of the changed demand for, or supply of, a security to negotiate prices with market-makers.

152 This problem is diminished with respect to listed securities, the trading volume of which is available (except for "third" or "fourth" market transactions) and may offer some basis for determining whether block traders are in the market for the stock. It is, however, impossible to ascertain from volume alone whether an institution is buying or selling a large block, and unless such programs are gradual and geared to market supply or demand, knowledge thereof may still be material.

153 The classification of insiders as either "inner" or "outer," the latter being

from taking investment action or tipping as "inner insiders," except to that extent that their distance[154] from the central source of data indicates its non-materiality, because such conduct by either form of insider is conducive to "inherent unfairness."[155] Another reason for tippee liability is the second major objective underlying Rule 10b-5 as applied in civil actions, that of compensating those injured by the misuse of inside information. Promoting the flow of accurate and reliable information, as well as the achievement of this deterrent objective would also suggest holding tippees liable as "tippors" for aggravating these problems by continuing to pass such information.

Since in many cases the tippee will have received the only profit from the transaction, tippees would seem the most appropriate parties to make compensation.[156] However, in order to preserve the necessary deterrent effect of a proscription against tipping, tippors should also be held liable for damages as joint tortfeasors with their tippees.[157] Although section 10 of the Exchange Act makes no express provision for treating such parties as joint tortfeasors, this should be no obstacle to the courts for neither did the section provide for private rights of action to redress violations of section 10(b) and the rules promulgated thereunder; moreover, joint and several liability finds ample precedent in the law of torts which Rule 10b-5 so closely resembles in many respects,[158] and in the collective liabilities of controlling and controlled persons under section 20(a) of the Exchange Act.[159]

The foregoing discussion has, of course, assumed the materiality of the information acted upon by tippees. Another limitation on tippee liability suggested by the opinion in *Texas Gulf* is a require-

essentially tippees, has been borrowed from Professor Bromberg. *See* PLI TRANSCRIPT, *supra* note 87, at 213, 215.

154 *See id.* at 208-10, 214.

155 *See* text accompanying notes 81-91, *supra. See also* 82 HARV. L. REV. 938, 942 (1969).

156 *See id.* at 943.

157 *But see id.*, finding this result unlikely under present law.

158 For example, the Rule 10b-5 concepts of standards of conduct to be enforced by deterrent rules, proximate causation and the absence of a privity requirement have all been borrowed, in some form, from the law of torts.

159 15 U.S.C. § 78t(a). This provision reads as follows:

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

ment that "they acted with actual or constructive knowledge that the material information was undisclosed . . ."[160] However, to the extent that a potential tippee can reasonably be expected to ascertain from a broker or otherwise whether information is in fact public, the "constructive knowledge" *caveat* would seem to eliminate this possible defense and restrict its applicability to the relatively rare situation in which the tippee is misinformed by his broker or by his informant. Conversely, this standard of, in effect, due diligence should, consistently with the *Texas Gulf* disposition of the insiders' claims of good faith, be applied to render a tippor liable for passing material inside information unless he reasonably believes that it will not be misused, *i.e.*, acted upon or unnecessarily transmitted, by the recipient of the information.[161] It would seem, however, that such a belief would rarely, if ever, be reasonable when information is communicated for no corporate or other legitimate purpose.[162]

One further point merits discussion in the context of the tipping. Specificity and reliability are, as noted earlier, pertinent factors in determining materiality. In many tipping situations, however, the relationship between the tippor and tippee is so close that the tippee has sufficient knowledge as to the tippor and his source that reliability may be assumed and specificity not required.

For example, although Darke, the TGS geologist held liable for tipping, had been proven only to have generally recommended TGS stock, the court, with the inferential aid of the unusually speculative and large tippee transactions and their timing, found liability.[163] Two members of the majority preferred to remand for a finding

160 *Id.* at 853. The Second Circuit in *Texas Gulf* has already treated such trading by relatives or nominees of "inner" insiders as the latter's violation and, presumably, responsibility in the event of damages. *See* 401 F.2d at 841 n.4, 856 n.23; *see also* Bromberg PLI TRANSCRIPT, *supra* note 87, at 230. Such liability appears to be grounded on Section 20(b) of the Exchange Act, 15 U.S.C. § 78t(b), which prohibits one from using another person to perform an act prohibited under the Exchange Act or any rule or regulation thereunder."

161 *See* Bromberg, PLI TRANSCRIPT, *supra* note 87, at 214-15.

162 To restrict the transmittal of material undisclosed information to those who have a "need to know" would be more consistent with the deterrent purpose of the Rule in view of the great temptations placed on recipients of such information and the difficulties in policing remote tippees. *See, e.g.*, the Statement of Policy adopted by Merrill Lynch in settlement with the S.E.C. requiring all non-public information to be clearly identified as such with the instruction that it "is to be used by the recipient solely for the purpose of carrying out his responsibilities . . . and not to be disclosed orally or in writing for any other purpose." Merrill Lynch, *supra* note 86, at 83,351.

163 401 F.2d at 852.

> as to whether, Darke, expressly *or by implication,* transmitted to these outsiders *any indication* of the extremely favorable results of the drilling operation in which he was engaged . . .[164] (Emphasis supplied.)

The significance of this statement is twofold: First, the revelation of some "indication," however *undetailed,* of the favorable drilling progress was apparently considered sufficient, at least by Judges Waterman and Anderson, to predicate a *tipping* violation by Darke, an "inner insider," in the same vein that *transactional* violations by Huntington and Kline, also "inner insiders," were found on the basis of their *general* knowledge of the drilling. In a tipping context, as in a transactional setting, the theoretical justification for such a standard is that actions by inner insiders are both more reliable and revealing to others, their tippees, and more likely to be based on a reliable understanding of the material development. Second, and related, is the reference to tipping "by implication." The majority in *Texas Gulf* could reasonably have assumed, and probably did, that Darke's tippees, apparently good friends of his, had previously learned at least of the nature of his work as a geologist and his whereabouts and could easily have inferred from his reactions to the subject of TGS and from his general recommendation that something extremely good was happening; and, of course, a good friend would not give his tippees a "bum steer" or suggest to those he knew to be irregular investors that they take substantial risks.[165] Thus, although such inferences, and the consequential devaluation of the specificity and reliability factors, may not be justified where the tippor-tippee relationship is distant, they seem quite justifiable in the *Texas Gulf* situation and in many normal tipping contexts.

D. *Stock Options*

The portion of the *Texas Gulf* opinion dealing with the issuance of stock options is of considerable theoretical importance since the rationale adopted, *i.e.,* Rule 10b-5 applies to protect the uninformed issuer (and presumably its constituent shareholders), as well as the investing public, from the inherent unfairness attendant in the issuance to insiders of securities for less than their intended consideration is a significant expansion of prior authority and comes

---

164 *Id.* at 852-53 n.16.

165 Tippees, of course, bear the risk of loss if the tips prove inaccurate. *See, e.g.,* Kuehnert v. Texstar Corp., CCH FED. SEC. L. REP. ¶ 92,282 (S.D.Tex. No. 66-H-396, Feb. 27, 1968).

close to effecting internal corporate affairs traditionally regulated only by state law.[166]

As previously observed, the basic difference between the positions of the *Texas Gulf* majority and the dissenters is that the latter would, on the facts presented, have permitted the insiders to accept options so long as they did not exercise them until after disclosure,[167] a proposal which the majority would reserve only for situations in which corporate security forbade both any communication to the option committee and rejection of the options.[168] The rule adopted by the majority for the usual case where, as in *Texas Gulf*, no such dilemma was demonstrated, required members of "top management" either to disclose their material non-public information to the issuing body or to reject the options.[169] Optionees below the level of "top management" were excused from any obligation since they could reasonably assume that their superiors had made disclosure.[170]

On the facts of the case, this resolution was undoubtedly correct. As Judge Friendly astutely observed, there is no reason why, in the normal case, members of option committees who are commonly directors cannot be entrusted with information as to extraordinary corporate developments or, at least, with the advice that the issuance of options was then inappropriate.[171] In the abnormal case, however, the majority's alternative bears considerable merit[172]

166 The reasoning adopted by the majority would also seem applicable to the issuance of convertible debt or equity security, as well as warrants, whenever the conversion ratio or exercise price is set by reference to the actual or presumed market value at the time of issuance. *See* Sargent, PLI TRANSCRIPT, *supra* note 87, at 326-27 (by implication).

167 401 F.2d at 877-78.

168 *Id.* at 857 n.24.

169 *Id.* at 856-57.

170 *Id.* at 857.

171 *Id.* at 865.

172 This alternative proposal has been unduly criticized for permitting insiders to gain windfalls upon post-disclosure ratification. *See* Sargent, PLI TRANSCRIPT, *supra* note 87, at 249-55. However, it should be noted that such ratification need not be automatic as members of the ratifying committee would be subject to shareholder derivative suits for corporate waste if their decision to grant the windfall to the insiders were not the product of reasonable business judgment. Also, as noted by Mr. Sargent, once disclosure has been made, the issuer has no longer been *deceived,* and the profits received by insiders are not *unfairly* kept if the corporation consents. *Id.* at 250. Moreover, since qualified options must be issued at a price not less than fair market value on the date of issuance in order to receive preferential tax treatment [*see* INT. REV. CODE of 1954, § 422(b)(4)] and pursuant to a plan which so specifies [see id., § 422(b)(a)], rescission rather than ratification may be desirable if the Internal Revenue Service should determine that fair market value should reflect undisclosed favorable developments.

for it is not inconceivable that even outside directors on an option committee may have sufficient general knowledge of significant potential developments as to be able to interpret even general instructions to postpone issuance as clearly favorable or unfavorable; and, if they additionally have either a personal interest in the development or financial problems, the temptation to breach the corporate confidence may be great. In any event, however, Judge Friendly is quite correct in implying that option committees, as well as boards of directors, should be staffed with persons who can be trusted with confidential information. And, in some cases at least, the rejection of options need not necessarily be construed as a favorable sign, for the prospective optionees may be expecting a market decline and prefer to await issuance at a lower price without jeopardizing their tax position.[173]

There may also be some question as to the status of a lower level employee who receives options while in possession of material inside information. Where he can *reasonably* assume disclosure has been made, as the majority thought was the case in *Texas Gulf*, he clearly should not be responsible for deciding whether and to what extent to disclose or how to reject the options. If, however, he knows or has reason to believe that disclosure has *not* been made, no good reason appears why he should not be required to abstain, as are "outer insiders" in non-option cases who are unable to disclose, and reject the options, citing, if necessary, personal reasons; at the very least, he should not be permitted to exercise the options prior to a post-disclosure ratification. While members of "top management" may be ultimately responsible to the corporation for his windfall under several theories,[174] he need not take advantage of such a windfall at their expense or that of the corporation.

Further in this connection, it is interesting to note that when the material inside information concealed from an option commit-

---

173 Under INT. REV. CODE of 1954, § 422(b)(5), a qualified stock option (receiving preferential tax treatment) is not exercisable while there remains outstanding any previously granted qualified or restricted option. Thus, an optionee would first have to exercise prior options at a higher price before he could benefit from the lower option price later awarded him.

174 At 401 F.2d at 865, Judge Friendly suggested the possibility that top management be held liable for damages suffered as a result of the untimely issuance of options. *See also* text at notes *supra*, suggesting tippors' liability as controlling persons under section 20(a) of the Exchange Act, a theory which would seem equally applicable where top management controls the non-disclosure and acceptance of options by lower-level employees.

tee is *adverse* to the company or its securities,[175] the issuance of options, may, in a rare case, also be injurious. In view of the tax disadvantages to uninformed recipients of qualified options with respect to subsequently acquired options exercisable at a lower price, such optionees may be damaged by accepting options from an issuer with material inside information which, if they knew the adverse information, they would reject in anticipation of later receiving more favorably priced options. In this manner, the issuer may profit by ultimately selling its underlying securities at a price higher than would otherwise be obtained, and this seems inherently unfair.[176]

Conversely, if the issuer is uninformed and the optionees are insiders, their rejection of options because of their adverse inside information seems inequitable vis-à-vis both uninformed optionees who accept and the issuer. If all of the optionees are knowledgeable, their rejection of the options theoretically causes no injury to the corporation since the acceptance or rejection by employees is discretionary. Nevertheless, the issuer may, in fact, have been caused to issue securities at a lower price than would otherwise have been obtained were it not for the optionees' inside information, and this seems equally unfair as the granting of options by a knowledgeable issuer to uninformed employees who would not accept if they too were informed.

Finally, it should be noted that Rule 10b-5 restricts insiders only from accepting but not from exercising options or, for that matter, exercising warrants or converting other securities, issued to them when they had no material undisclosed information.[177] The rationale for this proposition is that since the exercise price or conversation rate was set at a time when they were on equal footing with other security holders and the issuer. They cannot profit unfairly by subsequently exercising or converting, itself a discretionary act. In the unusual case where the optionee, warrantholder, or holder of a convertible security would clearly not have exercised or converted within the period prescribed therefor but for his material inside information,[178] it might seem unfair to the issuer to permit such

175 This situation is highly unlikely where knowledgeable members of top management are slated to receive qualified options for the reasons stated in note 173 *supra*, and accompanying text.

176 This would also seem to violate sections 11 and 12 of the Securities Act of 1933 if the options are registered; if unregistered, section 5 might be violated since the issuance of options under such circumstances might not qualify for the exemption from registration provided by section 4(2).

177 *See* Schwartz, PLI TRANSCRIPT, *supra* note 87, at 262.

178 This would be the case where, *e.g.*, the market price was lower than the

investment action for it would not, arguably, otherwise have had to issue the underlying security at a price below the fair market value to be reflected upon disclosure. However, this analysis ignores the absolute right of such security holders to base their decision to exercise or convert on all information affecting the value of their privilege and the underlying security, whether or not such information is available to the issuer, who could not modify or nullify the privilege, or to the investing public generally.

E. *Effective Public Disclosure*

Two further problems raised or suggested in the *Texas Gulf* context are how and when does disclosure become effective so as to permit insider activity. Although the court did not undertake a definitive resolution of either issue, it did suggest certain valuable guidelines.

In rejecting the claims of Coates and Crawford who had placed orders before the formal TGS announcement of its ore strike was issued and disseminated, the majority first observed that insiders will not be permitted to "beat the news" by even initiating investment action, *i.e.*, placing orders before disclosure was effective.[179] The rationale for this position would seem also to apply to any other pre-disclosure action which would give insiders an investment advantage over other uninformed investors.[180]

This reasoning was also extended to prohibit the placement of orders immediately *after* disclosure "where the news is of a sort which is not readily translatable into investment action,"[181] in order to deprive insiders of any unfair advantage gained from their advance knowledge of material developments. Having set the minimum criterion where news may be instantaneously acted upon[182] as its reasonably anticipated, if not actual,[183] appearance over the Dow-

---

exercise price but the optionee had inside information which, when disclosed, could reasonably be expected to increase the market price beyond the exercise price. *See* Fleischer, PLI TRANSCRIPT, *supra* note 87, at 262.

179 401 F.2d at 853 n.17.

180 Judge Waterman's opinion declared that "insiders may not take advantage of their advance opportunity to evaluate the information . . . ," *id.* at 854 n.18, and that disclosure must be effective "[b]efore insiders may *act* upon material information . . . ," *id.* at 854 (emphasis supplied).

181 *Id.* at 854 n.18.

182 A major ore strike, new product discovery, sharp earnings change, substantial dividend change or tender offer might fall within this category as such events would commonly have a decisive reaction upon the reasonable investor.

183 *See* note 203, *infra.*

Jones "broad tape," the court wisely deferred more precise determinations for Commission rule-making.[184]

In further rejecting the TGS insiders' contention that the widespread circulation of rumors of a major strike coupled with Canadian dissemination of the information constituted effective disclosure,[185] the court made it clear that dissemination must be made in a manner reasonably calculated to reach all investors likely to be interested in the company's securities. Thus, for a foreign company whose securities are traded on an American exchange or widely traded within the United States,[186] dissemination through national[187] United States financial media would seem required.[188] Moreover, al-

[184] 401 F.2d at 854 n.18. The Commission is reportedly considering the establishment of a "reasonable waiting period" of twenty-four hours as a minimum which insiders must wait. Bromberg, PLI TRANSCRIPT, *supra* note 87, at 237. Though such a rule would provide some predictability for insiders without surrendering the vagueness deemed desirable by the Commission as a deterrent measure, *see* 82 HARV. L. REV. 938, 945-46 (1969), it would seem fairer to insiders at least to include a listing of events which may be acted upon immediately or within a shorter period of time after appearance over the "broad tape" or in a financial newspaper of general circulation, *e.g.*, the Wall Street Journal, The New York Times, Barron's and The National Observer have also been suggested as having sufficiently wide circulation among investors to qualify as a primary outlet. Sommer, PLI TRANSCRIPT, *supra* note 87, at 57. With respect to the waiting period referred to above, a rule requiring abstention only until the appearance of news in morning newspapers of sufficient circulation would seem fairer to insiders than any arbitrary period of time, though outsiders who watch the tape could still move more swiftly than the restricted insiders. However, the best solution to this inequity would be to require disclosure after the close of trading in the relevant market so that tape-watching outsiders will be unable to act until the next trading session, by which time the news will have been published and insiders liberated.

[185] 401 F.2d at 853. The court's conclusion on this point was also influenced by TGS's promise in its prior pessimistic release to fully disclose further developments by means of such formal releases to the American investing public.

[186] In this connection, Commisison Rule 12g3-2(a)(1) exempting from registration under the Exchange Act classes of securities of foreign issuers having fewer than 300 American shareholders may serve as a temporary guideline in determining when United States dissemination is required before insiders may trade in the security in United States markets.

[187] The New York Stock Exchange requires listed companies to release such information simultaneously to Dow Jones & Company, Inc. and to one or more of the national newswire services, *i.e.*, Associated Press, Reuters or United Press International, as well as to newspapers of general circulation which regularly publish financial news. Also suggested is dissemination to newspapers in cities where the company has principal offices or installations. NEW YORK STOCK EXCHANGE COMPANY MANUAL, Section A 2, Part II, A-24. (July 1968). In addition, publication in newspapers in areas where large numbers of stockholders reside would also seem appropriate.

[188] Of course, if the item is rejected by the national media of general circulation,

though an exclusive release to a trade publication of general circulation among security analysts specializing in the area might, arguably, suffice in the case of a development which could have investment significance only to such experts, this sort of development would also seem to require insiders to abide by an additional "waiting period" for analysis and evaluation by outsiders. Here, too, the safest means of disclosure would be dissemination to financial media of general circulation. Even in the case of small public companies having primarily local investor attraction such broad disclosure would be advisable, for a company and its insiders would seem remiss in not making significant news available either to non-stockholders[189] or to distant stockholders.

Another major problem not definitively resolved by *Texas Gulf* is the question of when must a company effect public disclosure. Although the majority here deferred to a corporation's "business judgment" and Commission and exchange requirements,[190] it would seem that public corporations or their managers must bear some responsibility for accurately divulging material developments as soon as legitimate corporate reasons for non-disclosure[191] have ceased to exist. This burden should certainly be imposed if the consequence of non-disclosure is, beyond unjustified injury and gain to ignorant shareholders alike, insider and tippee trading.[192] Liability

such rejection might constitute some objective evidence, either of non-materiality or that the company does not command national financial attention. *See* note 90, *supra*, and text accompanying note 196, *infra*.

189 *See* note 82, *supra*.

190 401 F.2d at 850 n.12. The Commission's periodic reporting requirements are contained in Forms 8-K and 10-K and do not compel immediate disclosure. *See* 2 CCH FED. SEC. L. REP. ¶¶ 31,003, 31,103. The New York Stock Exchange currently requires immediate release of news relating to, *inter alia*, earnings reports, dividend announcements, acquisitions, mergers, tender offers, stock splits, management changes, new products, contract awards, expansion plans and discoveries. NEW YORK STOCK EXCHANGE COMPANY MANUAL, *supra* note 187, at A-22.

191 Such reasons would include, *e.g.*, TGS's desire to acquire options on the remaining portions of the Kidd property as well as a tendering or acquiring company's desire to purchase as many shares of the target company as possible at the lowest possible price and without organized resistance.

192 In this regard, the New York Stock Exchange has suggested immediate public release of news, disclosure of which might otherwise be deemed premature, (1) when private disclosure is made to persons other than top management and their individual confidential advisors, at which point the maintenance of security is too difficult, or (2) if unusual market activity or a substantial price change in the company's stock should appear, which would signify insider or tippee trading. NEW YORK STOCK EXCHANGE COMPANY MANUAL, *supra* note 187, at A-19. Listed companies are urged to alert the stock watch department of the Exchange. *Id.* at A-23. Unlisted companies

in these circumstances might properly be grounded on the deterrent policy of Rule 10b-5 since the company and its managers can control those to whom such information is divulged,[193] as well as the timing of public disclosure.

Nor does an "open door" policy on the part of public companies satisfy their disclosure obligation to the public. Although the New York Stock Exchange appears to condone the divulgence of information to outsiders if it *would* willingly reveal it to other inquirers or the press, such willingness, however admirable, is insufficient.[194] All members of the investing public, who are entitled to "equal access" to material information, are unfortunately not in a position to initiate inquiries of all companies that may interest them. Moreover, however well-intentioned management may be, it would be totally impractical for knowledgeable and responsible members of management to be available to play, in effect, "Twenty Questions," with the probable result that only friends or professionals would receive the news.[195] If management is *willing* to release the matter to the press, there is no reason why it should not *do* so and save the public the intolerable burden of seeking out the information. Of course, if the financial media view the item as non-material and other relevant sources of dissemination are unavailable for similar reasons, management may safely rely on its "open-door" policy, but in the hopefully rare case where such rejection may not reasonably be viewed as based upon non-materiality, paid advertisements and/or letters to the investment community might merit some consideration as alternative vehicles of disclosure.[196]

F. *Insiders' Defenses*

This issue raises the question of the standard of conduct to be required of insiders to avoid violation of Rule 10b-5. There was no substantial disagreement among the members of the Second Circuit in *Texas Gulf* from the clear abandonment of the old *scienter* re-

should, it is submitted, report suspected insider activity to the Commission and/or the N.A.S.D.

193 The internal security measures adopted by some companies include requiring employees to pledge under oath not to use or divulge material inside information. *See* Wiesen, *supra* note 95, at 214 and the examples cited therein. Such a procedure may not provide an effective indemnity for the corporation in respect of the misconduct of financially irresponsible employees, but it is highly useful as a deterrent to such action.

194 New York Stock Exchange Company Manual, *supra* note 187, at p. A-20.

195 Wiesen, *supra* note 95, at 213.

196 *See* notes 185 and 188, *supra*.

quirement[197] as inconsistent with the deterrent objective of the Rule. Thus, the unreasonableness of the claims of certain TGS insiders that they, in good faith, believed the news of the ore strike was public was held to bar any defense on this ground.[198] A similar standard of reasonableness was implied in the court's dictum regarding the liability of tippees.[199]

In this context, it is feasible to determine the reasonableness of the conduct of each individual, whether insider or tippee, by reference to the conduct of the class of persons similarly situated without diminishing the force of either the deterrence or compensation[200] objectives of the Rule.[201] Thus, if a corporate manager were to give a confidential report in an unsealed envelope, or in no envelope at all, to a messenger with no instructions as to its nature and without taking any security precautions and the messenger traded or tipped, the manager would have acted unreasonably even if the messenger, perhaps because he had no access to a broker or other means of determining the inside nature of the information, had not. If, however, the recipient of the report were company counsel, no such instructions would be necessary from the manager because he could reasonably assume the other's knowledge of the nature of the information and the restriction on its use and the recipient would be acting unreasonably in using or passing the information. Similarly, the tippor's knowledge of the tippee's likelihood to yield to temptation may be considered in determining the reasonableness of his conduct; and, of course, the tippee's knowledge of the tippor's connection with the company and of the existence of legitimate purposes for the transmittal of the information may bear upon, not only the reliability components of materiality, but also, the tippee's responsibility for ultimate misuse of the information.

It has, however, been suggested that tippees *as a class* should be held to a lower standard of care than other insiders and that they might be permitted to defend on the ground that the information acted upon had already been disclosed when it appeared in rumors and other news stories, as in *Texas Gulf*.[202] Justification for this view

---

197 *See* Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951).

198 401 F.2d at 854-56.

199 *See id.*, at 853.

200 *See* text accompanying note 120, *supra*.

201 If tippors and tippees are held jointly and severally liable, as has been suggested *supra*, problems of apportioning liability between the two on the basis of relative culpability are likely to arise.

202 Bromberg, PLI TRANSCRIPT, *supra* note 87, at 213, 236.

can only derive from some inherent difference in the relative capacities of insiders and tippees to ascertain when information has become publicly available. However, while insiders may have more precise knowledge as to the timing and means of public disclosure, tippees may be equally capable of checking the financial sections of relevant publications, obtaining security reports and, if appropriate, asking brokers to watch the "broad tape" on their behalf for any news relating to the company. Since the time of anticipated, if not actual, appearance of the news in the financial media is, under *Texas Gulf*,[203] the minimum prerequisite to both insider and tippee investment action, there is no apparent basis for such a general distinction, though an individual's capacity to determine whether information is publicly available should be a major component of a defense based on reasonable care.

It has also been suggested that insiders should be held to a lesser standard of care in non-privity cases—private actions for damages by plaintiffs not transactionally related to the insider—because liability could far exceed the insider's potential profits and the reasonable conduct standard is not required for deterrence of acts done in good faith.[204] These bases do not, it is submitted, justify the substantial diminution in deterrent force which is likely to result in view of the difficulties either of negating good faith or establishing bad faith, willful or reckless misconduct.

Although the private remedies to be awarded in non-privity cases such as *Texas Gulf* have not yet been determined, it would seem that the fear of imposition of a gigantic liability upon an individual insider is premature, if not unlikely. A plaintiff would still be required to prove that he was injured as a direct result of the insider's trading activity and this would seem impossible if, as in *Texas Gulf*, the company had no affirmative duty to disclose and the plaintiffs had no right to know. More than likely, an uninformed investor who sold his TGS stock before disclosure of the ore strike *profited*

203 *See* 401 F.2d at 854. Although the court took the trouble to demonstrate that Coates could not reasonably have expected the TGS release to appear over the 'broad tape' when he placed his order, it would seem that the duty of reasonable care would normally require abstention until the actual appearance of the news to the extent that the burden of awaiting and verifying such appearance would not be unreasonable under the circumstances.

204 Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U. L. REV. 423, 441-42 (1968). Professor Ruder is willing to presume good faith on the part of insiders but this presumption has been forcefully contradicted. *See* Barnhart, *How Ethical Are Businessmen*, 39 HARV. BUS. REV. 6 (1961).

by the presence of the insiders in the market, for their buying may have enabled the sellers to receive a higher price. The buyers during that period may have been injured by being required to pay a higher price, but such injury would be so slight that a division of the insiders' profits among all such buyers would be sufficient compensation. And if the company were obligated to disclose, it or its managers, rather than insiders would be the proper defendants. With respect to the second claimed justification, it is sufficient to note that a good faith standard would not encourage insiders to exercise care in determining whether the material information has been effectively disclosed, and since only "inner insiders" can effect disclosure, such encouragement is essential.

Another possible defense available to an insider but not presented in *Texas Gulf* is that he did not "act" on his material inside information because he engaged in no transaction in the security concerned.[205] However, it should be noted that the underlying policy of Rule 10b-5 as construed in *Texas Gulf* is to prevent insiders from taking *any* unfair advantage of their inside knowledge.[206] The applicability of this policy to non-transactional violations is further supported by the court's inclusion within the concept of investment "activity" not only buying and selling, but also "holding" a security.[207] In this light, the prohibition against insider "action" must be broadly construed to preclude insiders from, *e.g.*, foregoing a transaction which they would clearly have engaged in but for their inside information.

In the case of brokers or security analysts, their receipt of material undisclosed information should not permit them to withhold a previously determined contrary recommendation or to withdraw a pre-existing one. Conversely, the receipt of material inside information which confirms a prior investment decision or recommendation should not per se preclude the consummation of such a predetermined course of action, though any action which would be extraordinary for the investor, broker or advisor would strengthen the per-

205 This issue bears certain similarities to the "purchase or sale" requirement imposed upon Rule 10b-5 plaintiffs to establish their standing to sue. This requirement appears to be in the process of gradual erosion by the courts, Electronic Specialty Co. v. International Controls Corp., CCH. FED. SEC. L. REP. 92, 323 (S.D.N.Y., Dec. 19, 1968), as was the privity requirement, *see* the opinion of the District Court in *Texas Gulf* 258 F. Supp. at 277.

206 *See* 401 F.2d at 854 n.18.

207 *Id.* at 849: ". . . material facts include . . . those which may affect the desire of investors to buy, sell or *hold* the company's securities." (Emphasis supplied.)

missible inference that he, as a reasonable investor, was influenced by, and acted upon, the material information. Thus, it would be advisable for brokers, investors, advisors and others who not infrequently receive material inside information to maintain detailed chronological records of both their investment decisions and their receipt of such information. After such receipt, no investment action should be taken which is not clearly warranted by reference to independent factors.

G. *Corporate Liability for Inaccurate Disclosures*

A highly significant section of the *Texas Gulf* opinion for public corporations is that dealing with TGS's potential liability for having issued a misleading press release. Essentially, it was held that a report could, but need not, be enjoined under Rule 10b-5(2) if it was materially misleading to the reasonable investor, *i.e.*, it led him to believe the material facts to be other than they were at the time, and the issuance of the report in its misleading form resulted from negligence.[208] The absence of proof of any actual or anticipated securities transaction was held not to bar the application of the Rule so long as the report was made "in a manner reasonably calculated to influence the investing public, *e.g.*, by means of the financial media."[209]

The general regulatory policy of discouraging the deception of investors to the maximum extent possible certainly explains, if it does not justify, the court's expansive reading of the "in connection with" phrase of the Rule, for the investor may be as easily deceived by a negligently prepared misleading report as by one conceived with "malice aforethought" and proof of a wrongful motive on the part of the issuer would be virtually impossible absent an actual

---

208 401 F.2d at 863.

209 *Id.* at 862. This language would presumably exclude from the aegis of Rule 10b-5 statements made in commercials and advertisements not reasonably likely to influence the investing public. Statements made to certain newspapers which regularly publish financial news and to certain periodicals widely circulated among investors generally, *e.g.*, *Barron's*, *Time*, *Business Week*, *Fortune*, *Forbes*, *Newsweek*, and *U.S. News & World Report*, might *a fortiori*, be classified within the financial media, though any such classification should more appropriately be developed by the Commission. It should, however, be noted that investors are so broadly dispersed throughout the reading and viewing public that any statement which would be material to a reasonable investor is likely to result in his reliance, virtually irrespective of the medium of its dissemination. Therefore, the policy of Rule 10b-5 would best be served by proscribing all false or misleading statements which would be material to the reasonable investor by inducing him to take immediate investment action.

securities transaction.[210] Moreover, aside from the deterrent objective, the regulatory interest in maintaining honest markets[211] based on accurate information suggests the necessity for *injunctive* relief to require withdrawal or correction of false or misleading statements, irrespective of *whether the issuer acted reasonably or unreasonably.* There is no reason in policy why a misleading release issued under pressure, as was claimed in *Texas Gulf,* and perhaps without negligence on the part of the issuer, should be permitted to stand uncorrected and continue to deceive the investing public. This purpose would not, of course, require injunctive relief after the true facts had been disclosed, as in *Texas Gulf,* and an issuer's reasonableness should still preclude its liability for damages and diminish the necessity of enjoining future misstatements.

In view of the solid authority for the general proposition that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required[212] in a suit for monetary damages,"[213] the *Texas Gulf* majority limited its application of a negligence standard in Rule 10b-5(2) situations to equitable actions for injunctive relief.[214] This limitation was obviously a compromise for the potential adoption of this standard in damage actions against corporate issuers of misleading statements apparently stirred considerable controversy among the members of the Second Circuit in *Texas Gulf.* However, even this slight expansion of the Rule to cover situations not involving actual or proposed securities transactions or manipulations by a defendant seems inconsistent with the language of section 10 (b), Rule 10b-5 and the Commission's intention in its promulgation, in light of its failure to apply the Rule to non-transactional cases in the 23 years prior to its filing of the *Texas Gulf* complaint.[215] It is submitted that, while the general policies

210 *Id.* at 860-61.

211 *See* H.R. Rep. 1383, 73d Cong., 2d Sess. 11 (1939).

212 Another of the elements required in damage actions, reliance, has essentially been preserved in equitable actions by the court's construction of the "in connection with" language as contingent upon the issuance of a corporate statement in a manner reasonably likely to cause investors generally to rely thereon. Retention of this element in the equitable context is necessary if the Congressional language is to be given any meaning and corporations are to be permitted to conduct a business separately from their issuance and promotion of securities. *See* note 207, *supra.*

213 401 F.2d 863, quoting from SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963).

214 401 F.2d at 863. The question was again raised and avoided in Heit v. Weitzen, 402 F.2d 909, 913-14 (2d Cir. 1968).

215 *See, e.g., In re* Ward La France Truck Corp., 13 S.E.C. 373 (1943); Cady, Roberts, *supra* note 77.

implicit in the Exchange Act and its regulatory scheme may require a still greater expansion of the scope of the Rule in the area of inaccurate disclosures, the needs of the investment community would best be served by an official congressional and/or Commission reformulation of such policies promulgated after full employment of their respective modes of investigative expertise.

The possible constitutional problems posed in penalizing statements by reference to vague or hitherto unknown standards are sufficiently serious to require consideration, even if it be assumed that Congress and the Commission have the power to impose severe penalties for negligent misstatements.[216] Unfortunately, the consequences flowing from the mere determination that a corporation has violated Rule 10b-5[217] are extremely grave in terms of the reaction of the investing public, as well as that of the Commission in future dealings. Such penalties should not be imposed in the case of good faith, though negligent, disclosure and certainly not when misstatements result from a non-negligent failure to comply with ambiguous or previously inarticulated guidelines. Nevertheless, the laudatory aim of protecting the investing public requires that the Commission have the authority to compel the correction (and the proper dissemination of such correction) of false or misleading statements, irrespective of the reasons for their deficiencies.

This dilemma is, however, more apparent than real. It should not be an insurmountable task for Congress and/or the Commission to re-examine this area of securities regulation and devise both more precise guidelines for disclosure and a procedural framework which would empower the Commission to seek a judicial determination of the materially false or misleading nature of corporate statements and, if necessary, their correction, while simultaneously removing the unnecessary stigma of fraud from disclosure unless the circumstances warrant the employment of Rule 10b-5 in its present form.

In contrast to the *Texas Gulf* majority, Judge Friendly was not content to leave the spectre of monetary liability for negligent misstatements for future resolution. He urged that more than negligence should be required in damage cases because a corporation's

216 This is apparently one of the issues raised by TGS in its application to the Supreme Court. *See* Wall St. Journal, Sep. 24, 1968, at 4, col. 1; *see also*, Wall St. Journal, Jan. 31, 1969, at 31, col. 2.

217 Rule 10b-5 is widely viewed as an 'antifraud' provision designed to deal with manipulative practices and was apparently so intended by the Commission at the time of its formulation. *See* S.E.A. Release No. 3230 (May 21, 1942). 401 F.2d at 913-14 (2d Cir. 1968).

enormous potential liability for negligent disclosure would necessarily deter corporations from disclosing and the negligence standard was inconsistent with congressional intention.[218] This view that some degree of true *scienter* should be an element of proof in damage actions has already been approved by some commentators,[219] and, significantly, was apparently shared by a majority of the Second Circuit.[220] It is submitted, however, that both the deterrence and compensation purposes of Rule 10b-5 require the employment of a negligence standard of conduct in damage actions, which standard can be implemented without the adverse effects foreseen by proponents of a *scienter* requirement.

The first of Judge Friendly's basic difficulties with the negligence standard, *i.e.*, the fear that corporations confronted with gigantic liabilities would disclose less, rather than more, as intended by the Rule, assumes both that such liability will be intolerable and that the companies concerned must be permitted to choose not to disclose. This latter assumption is, however, unpersuasive inasmuch as the courts, the Commission and/or the Exchanges already do or can, as previously suggested, affirmatively require accurate disclosure of material information at precise stages of development, or in the event of apparent insider activity.[221] The validity of the former assumption is similarly questionable for its underlying premise can be made to disappear by properly limiting the damages recoverable in such cases and by placing the onus of recovery on the shoulders of the true malfactors, the architects of false or misleading statements.[222]

Under an appropriate "tort" measure of damages,[223] the aggre-

---

218 401 F.2d at 867-68.

219 *See, e.g.*, Ruder, *supra* note 204 at 429-42; 82 HARV. L. REV. *contra*, Comment, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U.L. REV. 541, 549 (1968).

220 Judges Kaufman and Anderson concurred in this portion of Judge Friendly's opinion, 401 F.2d at 869, and so, presumably would the two dissenters.

221 *See* notes 190, 192, *supra*, and accompanying text.

222 Although imposition of liability upon the corporate issuer might achieve a loss-spreading effect by distributing it among shareholders and/or through insurance, the products liability analogy is inappropriate where, as in the case of negligent or willful misstatements, fault can be specifically allocated to promote the deterrence objective and innocent investors require maximum incentives. Members of corporate management who act with reasonable care will, of course, be fully insurable, *see* Comment, *Insuring Corporate Executives Against Liability Under Rule 10b-5: First Principles and Second Thoughts*, 63 NW. U. L. REV. 544, (1968), and be eligible for corporate indemnification since most states limit indemnificaiton only in cases of negligent or willful conduct, *see, e.g* Sections 4(a) and (b) of the Model Business Corporation Act, and specifically, DEL. CODE ANN., Title 8, § 145 (1967).

223 Consistent with the tort theory on which Rule 10b-5 civil liabiliy is predi-

gate liability, even in a case like *Texas Gulf*, would be a small fraction of the amount anticipated and but a few cents per share;[224] and, of

cated, *see* Comment, *Measurement of Damages in Private Actions Under Rule 10b-5*, 1968 WASH. U.L.Q. 165, 167 (1968), damages for material misstatements or omissions should be limited to those directly attributable to the misconduct upon which a plaintiff reasonably relied. A plaintiff's out-of-pocket loss, limiting recovery to the difference between the value given and that received as at the date of the transaction, has been the most common measure employed. *Id.* at 175. Thus, in the *Texas Gulf* situation, a shareholdler induced to sell his TGS stock by the first pessimistic press release would not be awarded the per share difference between his sale price and the subsequent "high" at which the stock traded, but would be limited by the market price shortly after full disclosure, the actual value of his shares at the time of the sale. Such a limitation is not inequitable to the plaintiff in depriving him of a later windfall (recovery of which would, in effect, be tantamount to awarding punitive damages) because he could have properly earned such subsequently accruing profits by using his sales proceeds to buy back into the stock or "covering" his potential loss. *Cf.* Steinthal v. Cohn, 16 N.Y.2d 767, 262 N.Y.S.2d 494 (1965). Similarly, a buyer plaintiff could cover his losses by selling upon disclosure. The recent cases adopting different measures of damages do not contradict this basic principle for they concerned plaintiffs who, because the stock fradulently sold was not publicly traded, could not so cover their losses by repurchasing. *See, e.g.*, Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 939 (1965); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967).

224 For example, the aggregate potential damages of TGS calculated by Professor Ruder was approximately $139 million. Ruder, *supra*, note 203, at 429. This figure incorrectly includes *all* stock sold from November 12, 1963, the date K55-1 was drilled, until April 16, 1964, when full disclosure was made; it has, however, nowhere been suggested that TGS be liable for any sales prior to its April 12 press release, and only then because it may have been misleading. In calculating probable damages under the principles suggested in note 215, *supra*, the 691,000 shares traded from April 12 to April 16 must first be adjusted by some deduction from the 126,500 shares sold on April 13 to exclude those shares not sold in reliance upon the April 12 statement because, *e.g.*, the orders had been placed prior to their having read the pessimistic release or were the product of profit-taking; a similar deduction from the 444,200 shares traded on April 16 must be made to exclude those shares sold after the TGS announcement appeared on the "broad tape" in the first hour of trading. Assuming, *arguendo*, that as many as 75% of the shares sold on April 13 and 16 were sold in reliance on the April 12 release, and further, that such reliance could and would be proven by enterprising plaintiffs, only approximately 550,000 shares are entitled to be included in a calculation of damages. Next, it is noteworthy that, although the price of TGS stock ranged from 28⅞ to 32 during this period, the great majority of the sales occurred on April 13, when the low price was 30⅝ and on April 16, when it was 30⅛. Thus an average selling price for the potential plaintiffs would probably be no less than 29¾. If this is deducted from 33¼, an approximate mean price on April 16, by which time a reasonable investor would have heard the news of the ore strike and could have regained his position in TGS stock, we obtain a conservatively high damage estimate of 3½ per share, or an aggregate of approximately $1.825 million. This amounts to only about $.06 for each of the

course, if application of a different measure of damages would result in excessive liability, legal reform should be directed to placing a realistic limitation on damages rather than to lowering the standard of conduct required to effectuate full and accurate disclosure of material information and depriving innocent victims of careless corporate draftsmen of compensation for their actual and provable injuries. The inevitable consequences of imposing an obligation of reasonable care upon management in the disclosure of material information would be the more diligent conduct of management and the increased utilization of legal services, which can only be considered desirable.

The second prong of Judge Friendly's argument, *i.e.*, that the imposition of such liability absent a showing of some wrongful purpose is unwarranted by congressional intention in enacting section 10(b), also appears insufficient to justify denying compensation to victims of corporate misstatements. The liability provisions of the Securities Act of 1933 to which he refers[225] all embody, in effect, negligence standards of liability[226] with no substantially greater procedural requirements.[227] Although section 18 of the Exchange Act[228] contains a good faith defense, that section applies only to documents filed with the Commission (much of the information in which would not be material even under the expanded test proposed herein for

30,299,352 shares of TGS stock outstanding on May 6, 1968. 1968 MOODY'S INDUS. MANUAL 2276.

225 401 F.2d at 867.

226 *See* §§ 11, 12 and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77K, 77L and 77q. A standard of reasonable care has been applied in actions based on Section 17(a)(2), from which the language of Rule 10b-5(b) is taken, in both civil cases, *e.g.*, First Trust & Savings Bank of Zanesville, Ohio v. Fidelity-Philadelphia Trust Co., 112 F. Supp. 761 (E.D. Pa. 1953), *aff'd*, 214 F.2d 320 (3d Cir. 1953), *cert. denied*, 348 U.S. 856 (1954); Dack v. Shannon, 227 F. Supp. 26 (S.D.N.Y. 1964); *see* S.E.C. v. VanHorn, 371 F.2d 181, 184-86 (7th Cir. 1966); *but see*, Thiele v. Shields, 131 F. Supp. 416, 419 (S.D.N.Y. 1955); and criminal proceedings, *e.g.*, Greenhill v. United States, 298 F.2d 405 (5th Cir. 1962), *cert. denied*, 371 U.S. 830; 372 U.S. 968, *rehearing denied*, 373 U.S. 947 (1963); *see* United States v. Schaefer, 299 F.2d 625, 629 (7th Cir. 1962).

227 The 1933 Act provisions all have a one-year statute of limitations, apply only to sellers or offerors of securities and require proof of reliance. Section 10(b) of the Exchange Act, of course, did not expressly provide a private right of action and contains no statute of limitations but the materiality, reliance and "in connection with" requirements in Rule 10b-5 actions are ample restrictions on plaintiffs and the absence of a statute of limitations seems insignificant if, as suggested in note 215, *supra*, a plaintiff may not recover damages resulting from a windfall subsequent to his transaction.

228 15 U.S.C. § 78r.

Rule 10b-5 cases) rather than transmitted directly to the public which require considerably greater protection.[229] Moreover, a more apt analogy may be found in section 20(a) of the Exchange Act pursuant to which the liability of controlling persons is not subject to a good faith defense if they *indirectly* induced the transactions of their agents albeit without knowledge of the wrong.[230] In any event, however, Rule 10b-5 was fashioned by the Commission on section 17 of the 1933 Act, and not on any provision of the Exchange Act, in order to apply penalties to buyers as well as sellers[231] and should be read to adopt its standard of due diligence.[232] Finally, absent any legitimate concern for the imposition of excessive damages on corporate issuers,[233] there is no reason to apply a less rigorous standard of care to corporate draftsmen of false and misleading statements than to insiders or tippees who are held to a standard of reasonable care,[234] especially since the former are more likely to be financially responsible to compensate injured investors,[235] or to be insured for negligent conduct.

III. Conclusion

While the holding of *Texas Gulf* should have caused no great surprise and did not greatly depart from prior authority, the court's authoritative and extensive discussion of the policies underlying Rule 10b-5 has had the desirable effect of stimulating greater awareness by the investment community of the many problems inherent in a securities market which thrives on material corporate information. The foregoing discussion has sought to explore the far-reaching impli-

229 For example, the proxy material required to be filed under Section 14, 15 U.S.C. § 78m, is reviewed by the Commission before being transmitted to shareholders. The periodic reports required to be filed on Forms 8-K and 10K do, of course, reflect material developments previously disclosed to the public and, to the extent that Section 18 adopts a lesser standard of care than that proposed herein under Rule 10b-5, one can only observe that Congress probably did not conceive of the necessity for a private right of action in the Section 10(b) context. *See* Ruder, *Civil Liability Under Rule 10b-5, Judicial Revision of Legislative Intent,* 57 Nw. U.L. Rev. 627, 648-60 (1964); Comment, *supra* note 219, 43 N.Y.U.L. Rev. at 542. Thus, as in other areas of interpreting the Rule, we must proceed on the basis of what Congress *would* have intended rather than what was then, in fact, conceived.

230 *See* Myzel v. Fields, *supra,* note 223 at 738-39.

231 401 F.2d at 855 n.22.

232 *See* authorities cited in note 226, *supra.*

233 *See* text accompanying notes 221-24, *supra.*

234 *See* 401 F.2d at 854-56, *citing, inter alia,* Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).

235 *See* note 224, *supra,* and accompanying text.

cations of Judge Waterman's landmark opinion and in light of these policies to suggest resolutions of issues not squarely presented in *Texas Gulf.*

Unquestionably, many problems await consideration, hopefully by the Commission after full utilization of the administrative process, and many of the solutions suggested herein will require legislative and/or administrative implementation, as well as judicial refinement. As a first step in this inevitable direction, it would be most helpful for the Commission to establish a special office to provide immediate, firm[236] advice to troubled insiders concerning materiality and timeliness of transactions and to corporations concerning the timing and form of disclosure.[237] Such a procedure could, at the very least, minimize the losses of ethical insiders without recourse to a minimum "waiting period" which would necessarily permit outsiders to act before insiders. In addition, the grave and legitimate liability fears of corporate management would be greatly alleviated by provision of, in effect, free liability insurance.

Finally, in this regard, the Commission should increase its police force. At the outset, increased enforcement should be directed to brokers and dealers who are the primary carriers of rumors and tips. Underwriting firms and banks, as well as financial publishers, should be required to institute internal security measures designed to segregate and identify material undisclosed information, and control its use in much the same way that the government treats classified information.[238] Similarly, public corporations and the foregoing members of the investment community should undertake to educate their employees in order to enable them to recognize and deal with material undisclosed information. And, to the extent that the N.A.S.D. is incapable of operating an effective "stock-watch" program for over-the-counter securities, where the dangers of insider abuse are particularly great, the Commission should also actively supplement or effectuate this task.[239]

---

236 Such advice could take the form of an expedited "no action" letter confirming a determination on a given set of facts recorded from telephone inquiries; this advice should, of course, be persuasive (unless Commission revision of Rule 10b-5 renders it binding) on the facts given in private actions.

237 *Cf.* Comment, *supra* note 219, 43 N.Y.U.L. REV. at 561, generally suggesting the adoption of a Rule 10b-5 advisory procedure.

238 *See, e.g.,* the system adopted by Merrill Lynch, described in note 162, *supra.*

239 The Commission operates a partial "stock-watch" in over-the-counter securities but, because of the inaccessibility of trading volume data, this program is limited to price changes and changes in participating dealers. While significant volume changes

These measures are obviously expensive. Rather than funding them from general revenues it may be preferable to impose an additional securities transfer tax or to exact monetary penalties for culpable violations of the Rule which are payable ultimately to the Commission. Another possibility would be to utilize the disgorged insider profits which the Commission hopes to obtain in cases like *Texas Gulf* to defray its operating expenses. This seems more sensible than holding such profits for the accounts of unidentified potential plaintiffs or rewarding the few whose transactions can be matched with those of insiders. In addition, the probability that the only parties injured as a result of insider trading, as distinguished from false, misleading or non-disclosure, will be unable to demonstrate any substantial loss would indicate that few of them would ever become active plaintiffs, except insofar as class actions under Rule 10b-5 are permitted to promote the barretry practiced in section 16 actions.[240]

If these or other more appropriate measures are forthcoming, honest markets and a healthy investment community can indeed coexist.

---

are more likely to result in price changes in unlisted than in listed securities, the two do not always vary directly. Thus, at least for the purpose of facilitating early detection of possible insider activity, volume information should be supplied by market-makers to the Commission or the N.A.S.D. (whichever is to maintain a "stock-watch"), if not to the public. *See* note 151, *supra*.

240 *See*, e.g., Montague v. Electronic Corp. of America, 76 F. Supp. 933 (S.D. N.Y. 1948).